Cayman clawback orders against Weavering investors upheld

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In November 2016 the Cayman Islands Court of Appeal ("**CICA**") rejected Skandinaviska Enskilda Banken AB's (Publ) ("**SEB**") appeal against Mr Justice Clifford's decision to order that redemption proceeds of approximately US$8 million (the "**Redemption Payment**") should be repaid to the liquidation estate of Weavering Macro Fixed Income Fund Limited ("**Weavering**").

A copy of our article on the first instance Grand Court's decision can be found **here**.

Weavering was placed into liquidation in March 2009 when it was discovered that its investment manager, Magnus Peterson, had **masked large losses suffered through options trading with worthless swap transactions entered into with affiliated counterparties**. Shortly before the liquidation commenced, Mr Peterson directed that redemption proceeds of approximately US$8 million be paid to SEB leaving redemption payments to other creditors unsatisfied.

The Grand Court and CICA both determined that the Redemption Payment was a voidable preference under s.145 of the Cayman Companies Law, that had to be returned to the liquidation estate. A voidable preference is a payment made to a creditor within 6 months of the commencement of a liquidation where the company intended that the creditor be preferred over other creditors.

The appeal

There were a number of issues raised on appeal:-

Change of position is a defence to a restitutionary claim for the return of funds. The defence is premised on the inequity of a recipient having to return funds which have been spent or passed on in reliance on the payment.

Key to SEB's defence was the contention that, because s.145 of the Companies Law did not expressly provide a remedy in the event a payment was found to be a voidable preference, Weavering's claim was founded in restitution, and therefore SEB could seek to rely on the change of position defence.

The CICA rejected SEB's argument. It held that, despite the fact that the Companies Law did not expressly provide a remedy for a voidable preference, the consequence of such was that the payment is avoided and the recipient has to return the funds irrespective of their change of position in reliance on their entitlement to payment.

This ruling confirms the decision at first instance, and is immensely important for investors in Cayman Islands funds. In the event that an investor or a custodian receives a payment that is found to be a voidable preference, that investor or custodian will be liable to return the money regardless of its state of knowledge at the time of payment of the solvency of the transferor, and regardless of whether the payment has been distributed or used for other purposes.

This is likely to lead to tracing claims, but the logical consequences of this decision are that investors, custodians or nominees will be reluctant to distribute funds received from a Cayman Islands company until 6 months have elapsed or the custodian or nominee has made an independent inquiry into the solvency of the fund before distributing proceeds received from it. In SEB's case, a nominee shareholder, it had distributed the Redemption Payment to third parties. SEB had obtained contractual indemnities from the third parties but these were, in the CICA's words, "worthless". SEB therefore found itself in the position of being liable to repay the amounts received, despite being unable to recover those funds from those who ultimately benefitted.

2. Dishonesty requirement?

SEB sought to argue that Weavering had to show that there was a 'taint of dishonesty' before a voidable preference claim could succeed. The CICA disagreed and held that the legislation had moved on from the former 'fraudulent preference' basis, and any element of dishonesty had to be placed in its proper context. The mischief that the voidable preference legislation was designed to protect against was creditors of an insolvent company not being paid on a pari passu basis and some creditors suffering more than their proportionate share of the losses. Therefore, the liquidators did not have to establish that Mr Peterson was acting dishonestly when the Redemption Payment was made; only that he had intended to prefer one creditor over another.

One interesting point to note is the approach taken to the question of when an inference of an intention to prefer can be drawn. In RMF v DD Growth 2014 (2) CILR 316, applying the line of English authorities including Re Cutts [1956] 1 WLR 728, the Chief Justice found that where payment is made due to the commercial pressure exerted by a creditor, the inference of an intention to prefer was displaced. Re Cutts makes clear that not only commercial pressure but other examples including the intention "to obtain .. some immediate and material benefit"

On the facts in Weavering it was held at first instance that SEB was amongst redeemers selected for payment because they were intending to invest in an affiliate fund, and yet it was nevertheless held that this did not displace the inference of a intention to prefer. This does beg the question as to why a payment made in these circumstances would constitute a preference, when the payment in RMF does not. It seems arguable that the motivation to ensure that a creditor intending on investing in an affiliate fund is the type of "material benefit" contemplated in Re Cutts. If the mischief that the voidable legislation seeks to avoid is some creditors bearing a disproportionate share of the losses, it is not clear why responding to the commercial pressure exerted by one creditor should displace the inference of preference but the promise of investment in another of the manager's fund does not.

However, the Court of Appeal held that on the facts it was not possible to infer a dominant intention to prefer (except in relation to one payment) on the grounds that the creditor was to invest in the affiliate fund. This makes it clear that the question of whether a payment was made with the requisite intention will very much turn on its facts. It is now confirmed at least that dishonesty is not a necessary component.

This position is in sharp contrast to the Exempted Limited Partnership Law and the new Limited Liability Companies Law where a clawback claim can only succeed when the recipient has actual knowledge of the insolvency of the ELP or LLC.

3. <u>The solvency issue</u>

SEB argued that Weavering was not insolvent when the Redemption Payment was made and could not therefore be characterised as a voidable preference. The solvency argument was advanced on 3 separate grounds:-

> i) Because the Net Asset Value ("**NAV**") of Weavering was calculated on the basis of a fraud, there were no actual debts due to investors, and the company could not therefore be said to be insolvent. The CICA held that despite Mr Peterson's fraud the NAV calculations were binding at the time they were made in accordance with the Privy Council's decision in **Quilvest Finance v Fairfield Sentry [2014] UKPC 9**;
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> ii) Weavering's articles of association provided that Weavering had a 30 day grace period within which any redemption proceeds must be paid. SEB argued that Weavering were not, therefore, obliged to make any payments during this 30 day period and there were

therefore no debts actually due (and therefore no insolvency) at the point in time that at least one of the Redemption Payments was made. The CICA, following *Culross Global SPC Ltd v Strategic Turnaround Master Partnership Ltd* (2010) (2) CILR 364 held that the 30 day period was a mere practical aspect of the process of payment and did not alter the fact that the redemption debt crystallised on the redemption date, and the debts had therefore fallen due; and

iii) SEB sought to argue that the cash flow insolvency test (i.e. whether a company can pay its debts as they fall due) prohibited the CICA from taking any future debts into account when assessing Weavering's insolvency. This meant that when the Redemption Payment was made the fund was not insolvent because some of the debts were future debts that should not be taken into account. The CICA held that a Court could take debts into consideration that will become due in the reasonably near future. This brings the application of the cash flow test in line with the English law position in which also looks to the ability of a company to pay its debts in the reasonably near future when considering whether a company is cash flow insolvent. What will amount to "reasonably near" will be fact specific but any such test will also have to take into account any future assets of the company.

Commentary

The Weavering liquidation has generated a number of interesting cases and the latest CICA decision is no exception.

Creditors will welcome the move towards a more realistic approach to the question of whether a company is cash flow insolvent, the confirmation by the CICA that liquidators do not have to establish an element of dishonesty when assessing whether a payment constitutes a voidable preference, and the confirmation that a change of position defence will not be available to avoid liability to repay a preference payment.

We anticipate however that the test as to whether a particular payment constitutes a preference will prove fertile ground for further litigation both in Cayman and elsewhere.

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