SEB v Weavering Court of Appeal Judgment

FIRST WEAVERING PREFERENCE CLAIM UPHELD BY COURT OF APPEAL

Earlier this year, the Cayman Islands Court of Appeal (**"CICA"**) heard the appeal of Skandinaviska Enskilda Banken AB (Publ) (**"SEB"**) against the 5 January 2016 order of Mr Justice Clifford of the Grand Court in *Conway and Walker (as joint official liquidators of Weavering Macro Fixed Income Fund Limited) v SEB[1]*. Justice Clifford had held that payments received by SEB from Weavering Macro Fixed Income Fund Ltd (the "**Company**") shortly prior to the Company's liquidation constituted voidable preferences and required SEB to repay those amounts to the Company's joint official liquidators ("**JOLs**").

The CICA handed down its judgment on 18 November 2016, unanimously dismissing SEB's appeal on all issues and taking the opportunity to comment on a number of principles of Cayman insolvency law in a way that is likely to have implications far beyond the world of voidable preferences. In early December, SEB filed notice of its intention to appeal the CICA's decision to the Privy Council.

BRIEF BACKGROUND

The Company was an open-ended investment company, trading mainly in interest rate derivatives, that went into liquidation on 19 March 2009. The liquidation was prompted by the discovery of fraud on the part of the principal of the Company's investment manager, Magnus Peterson. In 2015 Mr Peterson was convicted and sentenced to 13 years' imprisonment.

During the course of 2006 to 2008, SEB had subscribed for approximately US$9.5 million in redeemable participating shares in the Company as custodian and nominee for a number of clients.

Shortly after the collapse of Lehman Brothers in September 2008, many of the Company's investors sought to redeem their shares. This included SEB, which issued redemption notices in respect of all of its shares in October 2008 for a 1 December 2008 redemption day. As a result, redemptions totalling US$138.4 million became due to redeeming shareholders on 1 December 2008 (the "**December Redeemers**"). Redeeming shareholders with a 2 January 2009 redemption day (the "**January Redeemers**") were owed US$54.7 million. Redeeming shareholders with a 2 February 2009 redemption day (the "**February Redeemers**") were owed US$30 million.

The offering memorandum for the relevant shares stated that "Redemption payments are generally made within 30 calendar days after the Redemption Day".

SEB was paid just over US$1 million by the Company on 19 December 2008. It received a second payment of 25% of the balance of the redemption amounts owing to it on 2 January 2009 and a third and final payment of the remaining 75% on 11 February 2009. In total, SEB received approximately US$8.2 million in redemption payments (the "**SEB Redemption Payments**").

All but three large December redeemers had been paid their redemption claims in full by the time the Company went into liquidation on 19 March 2009. The January Redeemers and the February Redeemers were never paid.

THE FIRST INSTANCE DECISION

The Grand Court held that the SEB Redemption Payments were each invalid as a preference over the other creditors of the Company pursuant to section 145(1) of the Companies Law (the "**Law**") and ordered that SEB repay those amounts to the JOLs.

THE APPEAL

SEB appealed the Grand Court's decision on several different grounds, none of which succeeded. The CICA was asked to rule on three distinct issues:

- *The Solvency Issue – At the time that the Company made each of the SEB Redemption Payments, was the Company unable to pay its debts within the meaning of s93 of the Law?*
- *The Preference Issue – Were the three SEB redemption payments made with a view to giving SEB a preference over the other creditors?*
- *The Repayment Issues – Are common law defences available to SEB (such as the absence of unjust enrichment and change of position) or is the JOLs' claim against SEB contrary to public policy due to being founded on illegality, such that SEB should not be required to repay the claimed amounts?*

The Solvency Issue

It is a condition of the application of section 145(1) of the Law that for a payment to be held to be preferential the Company must have been insolvent within the meaning of section 93 of the Law at the time that the relevant payment was made.

The CICA upheld the first instance judge's finding that the JOLs had discharged their burden of proving that on the date of each of the SEB Redemption Payments the Company was unable to pay its debts. The Company was therefore insolvent within the meaning of section 93(c) of the Law. Each of the three points on which SEB had appealed the court's decision on solvency was rejected.

The Fraud Point

SEB contended that the published NAVs, which had assumed that certain swaps had the value fraudulently attributed to them by Mr Peterson, were not valuations within the meaning of the Company's Articles and that in the absence of any alternative figures stating the Company's true asset value, there was no material before the

Court on which it could conclude that the Company was insolvent at the relevant times.

The CICA rejected that contention, favouring instead the JOLs' submission that the reasoning in the Privy Council's decision in *Fairfield Sentry[2]* applicable to this case. In the Court's view, the published NAVs were binding in favour of redeemers and conclusive at the time of the SEB Redemption Payments notwithstanding that, because of Mr Peterson's fraud, the NAVs were, in fact, incorrect. The CICA noted that Article 34 of the Company's Articles of Association provided that any valuations of the Company's assets made in accordance with the Articles is binding on all persons, and that such a provision was fundamental to the mechanism by which investors in the Company acquired and redeemed shares.

The 30 Day Point

SEB contended that the 30 day window for payment post-Redemption Day, as stated in the relevant offering memorandum, meant that the Company was not in breach of contract until that 30 day window had passed without payment so the First SEB Redemption Payment, received within that 30 day window, was not preferring SEB over anyone else when made, as other December redeemers were not owed their money until the end of the 30 days.

The CICA rejected that contention, agreeing with the first instance judge that this issue had been concluded in *Culross Global SPC Ltd v Strategic Turnaround Master Partnership Ltd[3]* (and on appeal to the Privy Council*[4]*). The Privy Council in that case clearly rejected the proposition that a statement in an offering memorandum or similar document indicating when payment of a redemption price would be made prevents an immediate liability from arising on the redemption day. The redemption payments became due to the December Redeemers on 1 December 2008 and the CICA held that those amounts were properly taken into account by the first instance judge in determining whether the Company was solvent when the SEB Redemption Payments were made.

The Future Debts Point

This was an alternative formulation of the 30 Day Point. SEB contended that the first instance judge was wrong to treat the Company as insolvent on 19 December (the date of the first SEB Redemption Payment) because, on SEB's contention, no debt was due and payable in respect of the December Redeemers' claims until 31 December (30 days after the 1 December redemption date).

Having found that the redemption payments became due on the relevant redemption date and not 30 days later, the CICA did not have to take this point further, but it nevertheless explicitly rejected this interpretation of the insolvency test in Cayman. The Court held that the cash flow test of solvency in the Cayman Islands is not confined to consideration of debts that are immediately due and payable. It also permits consideration of debts that will become due and payable "in the reasonably near future". This is a significant departure from previous Cayman Islands authorities.

The Preference Issue

A further condition of the application of section 145(1) of the Law is that the payment said to be a preference

must be made to a creditor "with a view to giving such creditor a preference over other creditors".

SEB put forward several bases on which it contended that the first instance judge was wrong in his conclusion that this condition had been met.

The Dishonesty Point

SEB contended that the first instance judge erred in implicitly rejecting the need to find some evidence of dishonesty in order for a preference to be found.

The CICA disagreed. It confirmed that section 145(1) of the Law contains no implied requirement of dishonesty on the part of the Company in order for a payment to be preferential.

The Mistake Point

The first instance judge held that, based on the evidence, the Company had the intention of paying certain Swedish redeemers ahead of other December Redeemers (due to Mr Peterson's impression that those Swedish redeemers would be reinvesting the payments into another fund managed by him). The fact that Mr Peterson's impression may have been incorrect did not matter. The Company's intention to pay the Swedish redeemers first amounted to a dominant intention to prefer a particular class of creditors (of which the Company thought, correctly or not, SEB was a member), and resulted in a preference, in fact, of SEB.

SEB contended that, in the absence of any direct evidence from Mr Peterson as to how he was mistaken about the Swedish redeemers' intention to invest in the Swedish fund, it was equally plausible that Mr Peterson had simply highlighted the wrong investor and never had any intention to prefer SEB.

The CICA rejected that contention. It concluded that the evidence on why the first SEB Redemption Payment was made was clear: Mr Peterson wanted early payment to be made to a particular class of December Redeemers and had identified, rightly or wrongly, SEB as being a member of that class. That resulted in SEB receiving a payment from the Company that the Company intended to be made in preference to other creditors.

The Continuing Intention Point

The first instance judge concluded that not only did the Company have the dominant intention of preferring SEB (as a member of the class of Swedish redeemers) in respect of the first SEB Redemption Payment, but that such an intention also existed in respect of the second and third SEB Redemption Payments.

SEB challenged that conclusion in respect of the second and third SEB Redemption Payments, which were made after substantial payments had already been made to other investors.

The CICA agreed that there was insufficient evidence that the Company had the dominant intention to prefer SEB as a member of the class of Swedish redeemers in respect of the second and third SEB Redemption Payments and that the trial judge erred on this point.

However, that was not the only base on which the trial judge relied to support his finding that the second and third SEB Redemption Payments were preferential. The trial judge considered, in circumstances where he had found that Mr Peterson knew that the Company had no prospect of being able to pay the January and February Redeemers in full, that the Company's stated policy of making a 25% initial payment to the December Redeemers with the remaining 75% to be paid later, and of giving priority to redemptions that were not "large redemptions", reinforced the conclusion he had already reached.

The CICA held that these policies, in themselves, were sufficient to justify the trial judge's conclusion of a specific intention to prefer SEB in respect of the second and third SEB Redemption Payments, stating:

"*The proper course would have been to suspend redemptions (if that were by then possible) or liquidate the Company. [Peterson] nevertheless caused the Company to adopt a policy designed to allow the December redeemers to be paid before other redeemers. The Second SEB Redemption Payment and the Third SEB Redemption Payment were made pursuant to this policy, and had the intended effect of preferring SEB (as one of the class of December Redeemers) over the body of January Redeemers. SEB says that it was not preferred in the application of the policy, but that does not answer that point. Although the policy may have been applied consistently in relation to the December Redeemers, so that SEB gained no advantage over them, it did give SEB an advantage over the January Redeemers and (in the case of the Third SEB Redemption Payment) over the February Redeemers, all of whom were to the knowledge of Magnus Peterson unlikely to be paid. That is in my opinion sufficient to justify the judge's conclusion of a specific intention to prefer. As the judge recorded at [78], SEB did not put pressure on the Company to pay, or even request payment after giving notice of redemption, so there was nothing to displace the inference that SEB was paid pursuant to that intention*."

This amounts to a departure from current Cayman Islands and English authorities and is likely to be one of the issues challenged on SEB's appeal to the Privy Council.

The Repayment Issues

The repayment issues arise from the fact that, unlike the equivalent preference provisions in English statute, the Cayman Law does not explicitly direct that payments found to be preferential be repaid to the insolvent company; it only declares such payments to be 'invalid'.

SEB contended that, in the absence of any specific statutory right to claim repayment of preference amounts, liquidators must rely on a restitutionary remedy or a common law claim in unjust enrichment. If that is the case, SEB contended that common law defences, such as the absence of unjust enrichment and change of position must be able to be pleaded in defence to preference claims under section 145(1) of the Law.

The CICA rejected those contentions; holding that it is implicit in section 145(1) of the Law that, where the conditions of that section are satisfied, a preferential payment is automatically avoided and it (or its equivalent) is to be returned to the insolvent company. It confirmed that the first instance judge was right to reject the availability of common law defences to preference claims.

The CICA also explicitly rejected SEB's change of position defence on the facts, stating:

"[SEB] claims to have changed its position by paying the proceeds to Catella and HQ Solid [the clients on whose behalf SEB held the Weavering shares] in circumstances where it now has no ability to recover them; but the position in fact was that it paid them over on terms that included contractual indemnities. The deterioration in SEB's position stems not from its payment of the proceeds but from the fact that the indemnities have, according to the evidence, always been worthless. SEB's failure to procure a valuable indemnity or otherwise protect its position cannot be said to amount to a change of position sufficient to afford a defence to the preference claim."

In respect of SEB's contention that the JOL's claim was founded on illegality and was therefore contrary to public policy, the CICA held that, similar to the common law defences, the policy underlying section 145(1) – the necessity to procure pari passu distribution of available assets among all creditors – prevents those issues from arising.

COMMENTARY

While *Weavering* is, at its core, a preference case, the way that the CICA has dealt with issues in reaching its conclusions in this case will have a significant impact on a range of disputes reaching far beyond preference claims in Cayman. These issues include:

Definition of Insolvency

The CICA stated [at 40] that:

"*The cash flow test in the Cayman Islands is not confined to consideration of debts that are immediately due and payable. It permits consideration also of debts that will become due in the reasonably near future.*"

While this has long been the approach taken to the cash flow test in other Commonwealth jurisdictions where the statutory definition of insolvency explicitly incorporates a forward-looking element, until now it has not been understood that there was any forward-looking element in the Cayman test.

The cash flow test for insolvency in the Cayman Islands is set out at section 93(c) of the Law, which states:

"*A company shall be deemed to be unable to pay its debts if…. it is proved to the satisfaction of the Court that the company is unable to pay its debts.*"

This is to be contrasted with the equivalent provision at section 123(1)(e) of the English *Insolvency Act 1986* which states:

"A company is deemed unable to pay its debts… if it is proved to the satisfaction of the court that the company is unable to pay its debts ***as they fall due***" (emphasis added).

In *Weavering*, the CICA specifically took the view that the words "*as they fall due*" add nothing in substance to the test and stated *[5]*:

"*In Eurosail[6], Lord Walker, after noting that the words 'as they fall due' were introduced for the first time in the Insolvency Act 1985, said (again at [37]) that despite the difference in form they made little significant change in the law and served to underline that the cash flow test was concerned both with presently-due debts and with debts falling due in the reasonably near future. Any other conclusion leads to artificiality: if a company is able to pay a small debt due on a particular day, but will inevitably be unable to pay a much larger debt due on the following day, it is artificial to say that on the first day it is not unable to pay its debt.*"

This clarification of the cash flow insolvency test in Cayman means that Cayman companies must now incorporate a forward-looking element into their consideration of when they are at risk of being presently insolvent. What will constitute 'the reasonably near future' for the purposes of the test will be fact specific in each case.

Recalculation of NAV

As part of the fraud point used to dispute the first instance judge's finding of insolvency, SEB contended that because Weavering's published NAVs were calculated based on fraudulent information provided by Magus Peterson, they were not calculated in accordance with the Company's Articles and therefore not binding. As a result, SEB contended that none of the redeeming shareholders was entitled to be paid by reference to the published NAV*[7]*. Without those debts, or alternative figures stating the Company's true asset value at the relevant times, there was no evidence on which the Court could base a finding of insolvency.

In the recent case of *Primeo Fund v Pearson[8]*, Mr Justice Jones suggested that a NAV would not be binding if some conduct of an agent that could properly be imputed to a company had the effect of vitiating the contract between the company and its members. A distinction was drawn in that case between 'internal fraud', which would vitiate a valuation, and 'external fraud' which would not. As Weavering was a case of internal fraud, this would imply that the NAV could properly be recalculated. The CICA explicitly disagreed with that proposition stating:

"*There is in my view no difference between an internal and an external fraud in terms of the binding nature of a NAV: the whole scheme of the Company's articles requires its business to be conducted on the basis that the NAV is binding, whether it is accurate or not.*"

The CICA preferred the view expressed by Lord Sumption in the Privy Council's decision in *Fairfield Sentry v Migani[9]* that:

"If, as the articles clearly envisage, the subscription price and the redemption price are to be definitively ascertained at the time of the subscription or redemption, then the NAV per share on which those prices are based must be the one determined by the directors at the time, whether or not the determination was correctly carried out..."[10]

The rejection of the 'internal' v 'external' fraud distinction as expressed in *Primeo* and the limitation on a company's ability to recalculate NAV on the discovery of a fraud will no doubt be the subject of serious consideration in the other Cayman liquidations of investment vehicles where these issues are currently relevant.

Rejection of Change of Position Defence

The CICA's finding that no change of position defence is available will be of concern to custodians who receive redemption payments on behalf of their clients from financially distressed funds. The Court made it very clear that the fact that a custodian has paid out the proceeds of any redemption payment to or on behalf of its customer will not, in itself, provide it with any defence to a preference claim by a liquidator. It is up to the custodian to take steps to protect itself against that risk, whether through adequate indemnity arrangements or other means.

[1] [2015] (2) CILR 278 [2] [2014] UKPC 9 [3] 2008 CILR 447 [4] 2010 (2) CILR 364 [5] At [40] [6] *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* [2013] 1 WLR 1408 [7] SEB was effectively arguing that it should not have received any of the SEB Redemption Payments due to the fraudulent NAV. They were able to do this as any claim that the JOLs may have been able to bring to recover payments made by mistake based on the fraudulent NAV was time-barred. SEB asserted that it was entitled to make this argument to resist a finding of insolvency. [8] [2015(1) CILR 482] [9] [2014] UKPC 9, [2014] 1 CLC 611 [10] Ibid at [24]

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