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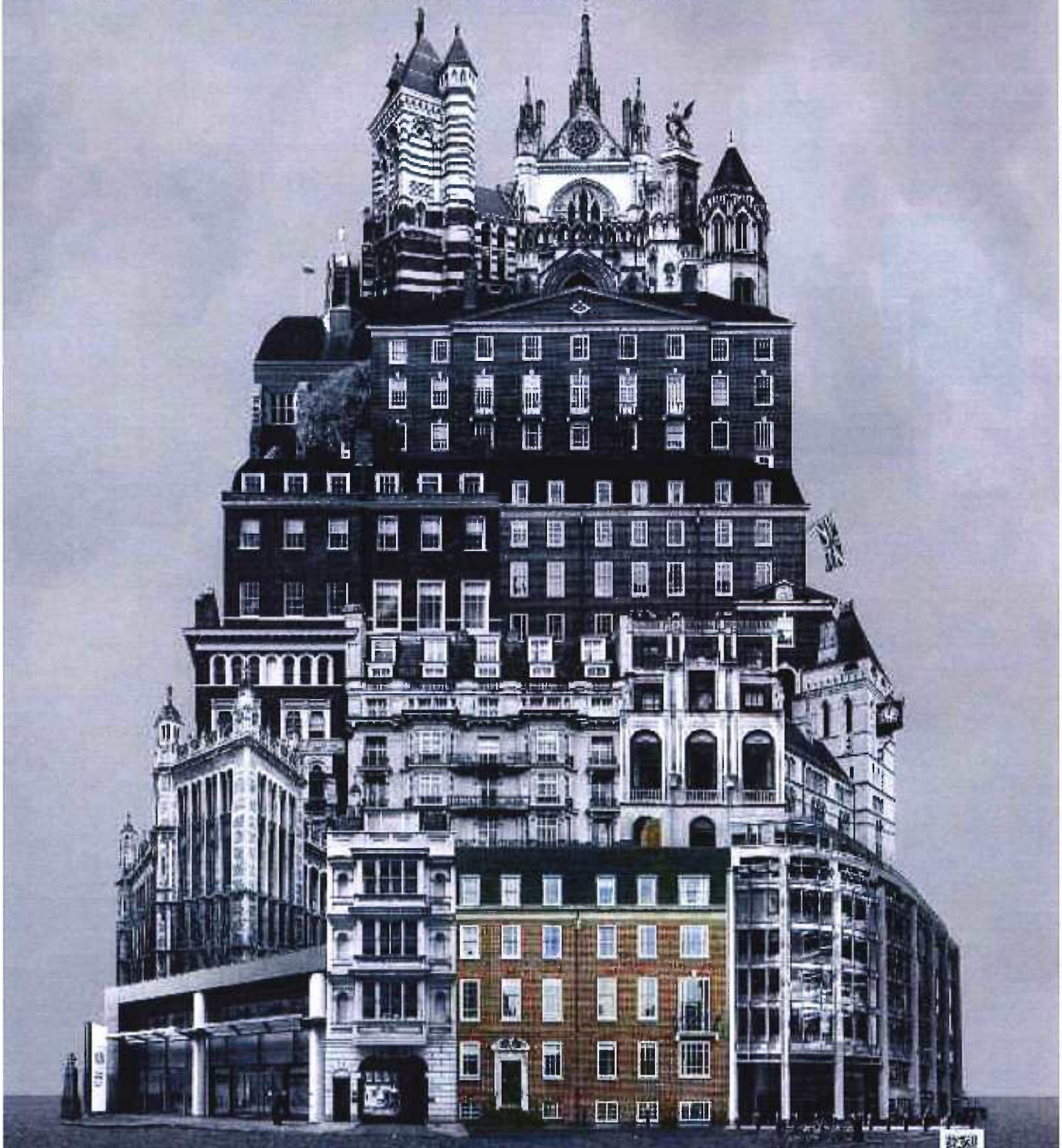

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Spotlight on the Cayman Islands

Ross McDonough and **Guy Manning** of Campbells review recent developments in the Cayman Islands

Insolvency: Cross Border Issues

Interesting issues have arisen and are likely to continue to arise as a result of the decision of the Chief Justice to wind up three Cayman Islands hedge funds, (collectively "the Soundview Funds"), Cause Nos. FSD 111, 112 and 113 of 2013. Winding up petitions were presented by disgruntled investors in respect of unpaid redemptions in August 2013[1] and petitions were listed for hearing on 24 September 2013. On the morning of 24 September 2013 (and before the commencement of the hearing in Cayman), management of the Soundview Funds presented petitions under Chapter 11 of the United States Bankruptcy Code in the Southern District of New York and those filings caused the automatic stay provisions under Chapter 11 to be invoked. At the hearing of the of winding up petitions in Cayman, the Soundview Funds' Counsel submitted that the Cayman Court could not then order the winding up of the Soundview Funds because to do so would violate the automatic stay under Chapter 11. That submission together with the further argument that the Chapter 11 filing would inevitably operate to render the Cayman Islands winding up proceedings as futile was given short shrift by the Chief Justice and he made winding up orders. In his ruling dated 13 December 2013 he expressed the view that in the circumstances of this case, comity dictated that there would be a need for recognition of the Cayman Court appointed liquidators by the United States Court.

The issue of whether the Chapter 11 proceedings are to be allowed to be continued has been argued before the United States Court and at the time of writing a decision on the various issues argued is still awaited.

In *Irving H Picard (as Trustee for the Liquidation of the Business of Bernard L. Madoff Investment Securities LLC) (In Securities Investor Protector Act Liquidation) and Bernard L. Madoff Investment Securities LLC (In Securities Investor Protection Act Liquidation) v. Primeo Fund (In Official Liquidation),* Grand Court of the Cayman Islands (Financial Services Division) (Cause No. FSD 275 of 2010), Jones, J., 14 January 2013 the Grand Court had to consider whether a foreign liquidator or bankruptcy trustee appointed by a foreign court in respect of a foreign company would, once recognised by the Grand Court, be permitted to bring statutory avoidance proceedings available to liquidators of Cayman companies under the Cayman Companies law.

In this case, Irving Picard had been appointed as Bankruptcy Trustee by the New York Court over the New York company that Bernard Madoff used to carry out his now notorious Ponzi scheme. An investment fund, Primeo, was an investor in Madoff's Ponzi scheme and received substantial sums prior to the fraud being discovered. Primeo did not know about the fraud. The Trustee sought to recover those sums from Primeo in the Cayman Islands. Primeo was a Cayman company that had only one connection with the USA, its investment in Madoff's Ponzi scheme. Three years previously the Trustee's appointment had been recognised by the Grand Court and he now sought the Grand Court's assistance in recovery of payments made to Primeo before the fraud was discovered.

The Court held that whilst the statutory powers contained in the Cayman statutes were for the exclusive

1/. If winding up orders were made on the petitions the winding up would be considered to have been commenced on that date.

CAYMAN JURISDICTION BECAME AN ISSUE IN FUND WINDING UP PETITIONS

benefit of Liquidators appointed by the Grand Court, nevertheless the Grand Court could assist the Trustee by granting him a direct cause of action in identical terms to the statutory powers. The Grand Court did this by extending established principles of recognition and assistance available to foreign office holders at common law, to include granting foreign office holders powers in Cayman that they do not enjoy under statute. This is a significant development. Previously, the limits of common law assistance that could be offered to foreign office holders had not been extended that far. Jurists generally agree that the local court should give assistance under common law comity principles to a foreign office holder to the extent that he or she should be recognised and permitted to take control of the foreign company's assets located in the Cayman Islands, able to require relevant people to give information about the company's dealings, and also able to obtain a stay of any Cayman proceedings against the company. However, granting direct causes of action in identical terms to statutory avoidance claims available to a Cayman Islands Liquidator, based on the principle of giving assistance to a foreign court (in this case the New York Court that appointed the Trustee), is quite a different thing altogether and represents a significant development in the common law of the Cayman Islands. The Judge said that his decision was made "not without some hesitation". An appeal has been heard and the decision of the Court of Appeal is awaited with interest.

Companies Winding Up: Striking Out

The Grand Court recently considered an application to strike out a winding up petition presented on the just and equitable ground on the ground that a fair offer had been made for the Petitioners' shares and that therefore the Petitioners had an adequate alternative remedy (in the matter of *Trikona Advisors Limited* [2012 (2) CILR Note 7]). Each of the petitioners owned

The Grand Court

The Grand Court was created as a court of special limited jurisdiction by statute in 1877. In its present modern form, the Grand Court was established by the Grand Court Law of 1975 and enshrined as a Constitutional Court in 1975. The Chief Justice, who has responsibility for "all matters arising in the judicature" is Honourable Anthony Smellie QC, JP

The Financial Services Division of the Grand Court was created in 2009 recognising the need for special procedures and skills in dealing with the more complex civil cases that arise out of the financial sector in the Cayman Islands

The current Financial Services Division judges are:

- The Chief Justice
- Hon. Angus Foster QC
- Hon. Alexander Henderson
- Hon. Andrew J. Jones QC
- Hon. Charles Quin QC
- Hon. Richard N Williams
- Sir Peter Creswell, DL

25% of the company, and the respondent the remaining 50%. Since 2009 the petitioners had been represented on the board of directors by C and the respondent by K. Due to disputes between the parties there was no prospect of any new business. Both C and K had been accused of breaches of fiduciary duty (in actions pending in Connecticut and New York), and K had removed C from the board of directors at a meeting of which C was not given notice. K wished to use the company's money to fund both the US proceedings against C and the defence of the winding up petition. The petitioners therefore applied to have provisional liquidators appointed (which would prevent K from using the company's funds in this way). The respondent applied to have the petition struck out on the grounds that the petitioners had an adequate alternative remedy or, alternatively, because the petition was being pursued for an improper purpose. In distinguishing certain of the principles set out by the House of Lords in *O'Neill v Philips* [1999] 2 All ER 961, the Grand Court held that the offer was not an adequate alternative remedy for four reasons:

1/. The proposed mechanism for determining the fair value was unnecessary and inappropriate because the company had no business or goodwill to value.

2/. The proposed payment for the shares was to be deferred until certain proceedings in the United States were concluded, which would have left the petitioners as subordinated creditors reliant on the future solvency of the company, which would have been jeopardized by the funding of the litigation.

3/. It was proposed that payment for the petitioners' shares would be set off against any judgment obtained against C (a former director who had a financial interest in the petitioners) or the companies alleged to be beneficiaries of C's alleged breaches of fiduciary duty (including the petitioners). However, C denied that the petitioners were his alter ego, with the result that the petitioners would have surrendered their right to have the liquidator prove any mutuality before a set off applied and;

4/. The offer to buy the shares was conditional on the failure of a claim for an order for the petitioners' shares to be forfeited which was asserted in the US proceedings. However the Judge held that any such order (for forfeiture) would not necessarily be recognised in the Cayman Islands.

The application was therefore dismissed and the winding up petition allowed to proceed to trial.[2]

Companies Winding Up: Segregated Portfolio Companies

In *ABC Company (SPC) v J & Co Ltd,* Court of Appeal of the Cayman Islands, May 2012[3] the Court of Appeal of the Cayman Islands was called upon to determine whether it was arguable that it would be just and equitable to wind up a segregated portfolio company ("SPC"), ABC, on the basis that, as a consequence of the suspension of NAV calculation in relation to one of the company's segregated portfolios (which had the effect of suspending subscription for and the redemption of shares in that portfolio), it was no longer possible for the company to meet its objectives, its substratum having thereby been lost.

ABC had many segregated portfolios which were all, in some way or another, involved in property investment. One of those segregated portfolios (the "German Fund") had suspended NAV calculation and the subscription and redemption of shares. The shareholder petitioned to wind up the entire company on the grounds of loss of substratum, notwithstanding that many other segregated portfolios were functioning normally.

The company brought an application to strike out the petition on the grounds that the shareholder had no realistic prospect of establishing that it was just and equitable to wind up the entire company. The strike out application was refused at first

2/. After a trial in January 2013, the Grand Court made an order for the winding up of the company.

3/. The parties' names were anonymised so as to avoid value destruction of the underlying portfolio assets, because the court was satisfied that if the company's name was published then potential purchasers might endeavor to force down the prices they pay for the assets upon the basis that the company was distressed.

instance and the company appealed.

The Court of Appeal held that under the terms of the recently amended offering documents (which had received the required 75% minimum vote from the German Fund's shareholders) the shareholders' reasonable expectation must have been that the suspension of the calculation of NAV could continue for some time, and therefore the objects of the company could not be said to have failed. Having come to that conclusion, the court held that the petition had no prospect of success[4].

While section 224 of the Companies Law provides an alternative to winding up for an insolvent segregated portfolio, namely the making of a receivership order over that portfolio, this option was not available to the petitioners because it could not be said that the segregated portfolio was insolvent.

The Court of Appeal observed that if an SPC company were the subject of a winding up petition on the basis of issues relating to a particular portfolio (and it was not possible to obtain a receivership order over that portfolio because it was not insolvent) then, provided that the court was satisfied that it *would* be just and equitable to wind up the company as a whole, an alternative order could be made under section 95(3) of the Companies Law which avoided a winding up order against the company but enabled the assets of the particular portfolio to be realised and distributed as if the portfolio were itself in liquidation (i.e. the equivalent to the making of a receivership order in respect of an insolvent portfolio pursuant to section 224 of the Companies Law).

In JP SPC4, Cause No. FSD 165 of 2012-AJEF, Foster J., 15 April 2013, a segregated portfolio company placed investments through one of its segregated portfolio in the form of loans to certain UK law firms for onward investment. The investments were lost and the Grand Court appointed receivers to the Segregated Portfolio. Upon appointment, the Receivers identified causes of action against the UK law firms who had received the investment monies. However, due to the fact that there is no concept of SPCs in English law, the Receivers were concerned that the English Courts might not render them assistance in pursuing the segregated portfolios' causes of action in England against the law firms. The Receivers sought the Grand Court's assistance in the form of a certificate for presentation to the English Courts confirming that their appointment was akin to that of a liquidator, and also requested the Grand Court to issue a letter of request for assistance to the English Courts. The Grand Court acceded to both requests.

Hedge Fund Issues: Side Letters

The Grand Court had considered the issue of enforceability of side letters in two cases in 2012, namely *Medley Opportunity Fund Ltd. v. Fintan Master Fund Ltd & Nautical Nominees Ltd* 2012 (1) CILR360 and *Lansdowne Limited & Silex Trust Company Limited v. Matador Investments Limited (In Liquidation) & Ors.* 2012 (2) CILR 81.

In summary it was held in both these cases that for a side letter to be enforceable the directors of a fund must have power, under the articles of association, to enter into side letters with investors, and that the side letter must be between the registered

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Court of Appeal of the Cayman Islands

The President of the Court of Appeal of the Cayman Islands is Rt. Honourable Sir John Chadwick. The other Justices of the Court of Appeal are:

- Hon Dr Abdulai Conteh
- Justice E Mottley
- Rt Honourable Sir Anthony Campbell
- Hon Sir Richard Ground
- Rt Honourable Sir Bernard Rix
- Honourable Sir George Newman
- John Martin QC

4/. There are currently conflicting decisions of the Caribbean courts as to when it can be said that a company has lost its substratum (i.e. when it can no longer do the thing that it was created for so that it should be put out of existence). In the Cayman Islands, the court has held that an open-ended mutual investment fund's substratum will be lost if the circumstances are such that it has become impractical, if not actually impossible, to carry on its investment business in accordance with the reasonable expectations of its participating shareholders, based upon the representations contained in its offering document. This notion was rejected by the BVI court which preferred the more traditional formulation that so long as the company can comply with some of its stated objects, in accordance with its bargain with its shareholders, then substratum will not have been lost. This issue is currently of considerable importance to the Caribbean investment fund industry and it was hoped that the present case would clarify the position in the Cayman Islands. Unfortunately it did not. While the appeal court made certain passing observations on the substratum issue and the differences in opinion on it between the Cayman court and the BVI court, it decided that this issue did not need to be determined on the appeal.

GUY MANNING

Members of Chambers who have appeared in Court in Cayman in the last 2 years.

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Gabriel Moss QC
Richard Sheldon QC
Richard Hacker QC
Mark Phillips QC
Robin Dicker QC
William Trower QC
Martin Pascoe QC
Antony Zacaroli QC
Felicity Toube QC
Ben Valentin
Tom Smith
Stephen Robins
Marcus Haywood
William Willson
Adam Al-Attar
Henry Phillips

shareholder and the fund.

In 2013, two further cases concerning the enforceability of side letters came before the Grand Court in quick succession. In *Swiss-Asia Genghis Hedge Fund v. Maoming Fund*, Cause No. FSD 12 of 2013, the Court was asked to enforce a side letter which the fund had entered into with the beneficial owner, rather than the registered holder, of certain of its shares. The fund had sought to argue, relying on the Medley decision, that it was not bound by the terms of the side letter and was free to disregard it. In his judgment dated 24 July 2013, the Hon Justice Jones distinguished the Medley case, and held that the commercial reality of the typical situation where the investor's shares in a fund are held by a nominee cloaked the investor with authority to bind the nominee when executing side letters and held that, in any event, the fund was "estopped by convention" from denying the enforceability of the side letter as the fund had partially performed certain of its terms. The judge explained that in reality the decision in Medley was that the side letter concerned was executed prior to the subscription agreement, which made no mention of it, and therefore the contract for subscription did not incorporate it. Although an appeal was filed in Swiss-Asia, it was not pursued.

After the trial in Swiss-Asia, but before Mr Justice Jones' decision was handed down, the Mr Justice Quin heard an appeal against a rejection of a proof of debt, the issue in which was again the enforceability of a side letter which had not been executed by the registered shareholder, but rather by the beneficial owner of the shares[5], *KBC Investments v Lancelot Investors Fund Ltd*, Cause No. FSD 87 of 2011. In his judgment dated 12 August 2013, Mr Justice Quin followed his own reasoning in Medley and Matador, and held again that only the registered shareholder (or his assignee) could enforce rights under the articles, notwithstanding the existence of a side letter. The judge was provided with a copy of Justice Jones' decision in Swiss-Asia, but did not refer to it in his judgment. This judgment is under appeal and the appeal is expected to be heard in March or April 2014.

Hedge Fund Issues: Sufficiency of a distribution in specie.

The Cayman Islands' Court of Appeal has now delivered its judgment in the case involving the winding up of FIA Leveraged Fund ("FIA"). FIA had appealed against a winding up order made on a creditors' petition by redeeming investors whom FIA had purported to pay by way of an in specie transfer of assets, rather than in cash. The Court of Appeal held that based on (fairly typical) wording in FIA's offering documents, an in specie distribution could only be made using assets from FIA's portfolio that were held by FIA at the time when the investor was entitled to be paid its redemption monies. Further, even though FIA's documents stated that its directors had a complete discretion as to the value of the assets to be distributed to investors, that discretion is still limited as a matter of necessary implication by concepts of honesty, good faith and genuineness and a need for the absence of arbitrariness, capriciousness, perversity and irrationality.

The Court of Appeal upheld the decision of the Grand Court in ordering the winding up of FIA, and found that there had not been a valid in specie distribution to the investors because the asset purportedly distributed did not exist in the FIA's portfolio at the time the investors were entitled to be paid their redemption monies, and was not of a sufficient value because the directors

5/. The side letter in this case had not been executed by the fund either but rather by the fund's Investment Manager purportedly on behalf of the fund.

had not acted rationally when valuing the asset.
Campbells acted for the successful petitioners.

Liquidation Funding: Conditional Fee Agreements ("CFAs")

Despite the fact that there are no statutory provisions expressly providing for the legality of CFAs, the Grand Court has held in the past that the competing public interest of ensuring access to justice for persons otherwise unable to fund litigation outweighed the risk of any improper incentive on the part of attorneys to succeed, and held that conditional fee agreements were, subject to considerations of reasonableness, legal in the Cayman Islands (*Quayum v. Hexagon Trust* [2002 CILR 161]). In a judgment dated 23 October 2013 in the matter of *DD Growth Premium II X Fund* (Cause No. FSD 0050 of 2009), the Chief Justice applied and extend the principles set out in *Quayum* and gave sanction to liquidators to enter into a conditional fee agreement relating to litigation to recover redemption payments made by a failed hedge fund to one of its investors prior to the hedge fund being wound up[6].

In considering whether the proposed uplift in the CFA was reasonable, the Grand Court followed English authorities on the subject, most notably *Spiralstem Ltd v Marks & Spencer plc* [2007] EWHC 90084 and *Callery v Gray* [2002] 1 WLR 2000, when calculating the "risk element" and followed the table set out in Cook on Costs to calculate the "postponement element". The Court stressed that under the present regime in Cayman there can be no question of an unsuccessful defendant being required to pay the uplift or success fee. Indeed the Court even alluded to the possibility that, because of various provisions of the practice direction which deals with taxation of costs on an inter-partes basis, the unsuccessful defendant may not be liable for the costs of the successful plaintiff at all.

The Chief Justice expressed the view that legislative intervention was necessary in this area to provide certainty and clarification. At the date of writing, the authors are unaware of any initiatives in this regard, but should the Chief Justice's invitation to the law revision commission be taken up it is also reasonable to assume that consideration will be given to legalising the entry into of damages based or contingency fee agreements.

Costs

In *Renova Resources Private Equity Limited* v. *Gilbertson et al* Grand Court of the Cayman Islands (Financial Services Division), Cause No. FSD 61 of 2011-AJEF, Foster J., 26 October 2012, the parties returned to Court after trial and delivery of the judgment to deal with ancillary issues including costs orders. The successful plaintiff had established that the defendant had breached its fiduciary duty but had failed to establish that it suffered any loss as a consequence of the breach. The judge observed that the parties had each experienced victories and defeats over the four years of the litigation as they conducted the interlocutory stages of the pre-trial litigation process. Also, the plaintiff's conduct with regard to disclosure had fallen short of the standards expected of a litigant and had caused increased costs and delays in the matter. The judge took into account the plaintiff's conduct and decided, notwithstanding the plaintiff's limited success, that the parties would each have to bear their own costs.

Possible future developments

The Cayman Islands Law Reform Commission has recently issued a consultation paper on the question of whether statutory codification of directors' duties is required or would be beneficial in the Cayman Islands. At the time of writing it is not known when the consultation process will be concluded.

Members of Chambers who have advised in relation to cases in Cayman in the last 2 years.

Michael Crystal QC
Gabriel Moss QC
Simon Mortimore QC
Richard Sheldon QC
Richard Hacker QC
Mark Phillips QC
Robin Dicker QC
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Martin Pascoe QC
David Alexander QC
Antony Zacaroli QC
Barry Isaacs QC
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Adam Goodison
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Henry Phillips
Charlotte Cooke

6/. The cause of action asserted by the liquidators is interesting (and so far untested) being a claim to recover payments made at a time when the fund was allegedly unable to pay its debts as they fell due in contravention of sections 34(2) and/or 37(6) of the Cayman Companies Law (2013 Revision).