BRIEFING

In specie distributions – further guidance from the Cayman Islands Court of Appeal

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Contacts:

Peter Hayden
Partner, Cayman Islands

Nicholas Fox
Managing Associate, Cayman Islands

Catherine Green
Senior Associate, Cayman Islands

For contact details, please see the end of this briefing.

On 18 February 2013, the Cayman Islands Court of Appeal released its judgment in Re FIA Leveraged Fund (the **Fund**). The judgment will be of significant interest to directors and managers of investment funds, as it provides helpful clarification as to what steps they will need to take to ensure that *in specie* distributions are effective and what their duties are when valuing assets to be used in these distributions.

Background

In summary, the background facts were as follows[1]. The Fund was a feeder fund in a multi-level master-feeder structure, which also involved:

- an Immediate Master Fund - which the Fund invested into directly; and
- an Ultimate Master Fund - which carried out most of the group's investment activities.

Three of the Fund's investors submitted full redemption requests. It was accepted that these shareholders had been entitled to redeem their investments and that they had done so effectively. However, a dispute arose regarding the validity of certain *in specie distributions* made by the Fund to them, in an attempt to discharge its payment obligations.

The relevant redemption date was 31 August 2011. Under the Fund's articles, payment to the redeeming shareholders fell due on 15 September 2011. However, the Fund made no payment for a number of months.

Some time later, the Fund's management incorporated a new company (**FILBCI**) and caused the Ultimate Master Fund to transfer certain assets to that company. Those assets included an option to buy shares in a bank (the **Option**).

On 13 February 2012, the Fund's management caused the shares in FILBCI to be transferred down the corporate structure to the Fund and then from the Fund onto its redeeming investors. Those transfers and distributions were approved in board meetings of the Immediate Master Fund and the Fund held respectively at 11:53pm and 11:55pm on 13 February 2013.

The redeeming investors disputed that the FILBCI shares were sufficiently valuable to discharge the redemption debts owed to them. In its decision, the Grand Court analysed the value of FILBCI's shares (which depended on the value of the assets that had been transferred by the Ultimate Master Fund to FILBCI, including the Option). It found that FILBCI's shares were worth substantially less than the sums owed to the redeeming investors and therefore that the transfer of those shares had not discharged the Fund's debt to them. The Fund appealed that decision. In considering the appeal, the Court of Appeal focused on two distinct issues.

Were the *in specie* distributions effective?

The first issue was whether or not the Fund actually had the power to transfer the FILBCI shares to its redeeming investors in satisfaction of the debt it owed to them.

The Court of Appeal held that the answer to this question turned on the construction of the Fund's articles and offering documents. The Court examined those documents and held that they provided the Fund with the power to satisfy redemption requests

[1] A more detailed background can be found in our May 2012 briefing analysing the Grand Court decision in this case: http://www.mourantozannes.com/media/710813/when_are_in_specie_distributions_effective_-_grand_court_provides_guidance_in_the_recent_case_of_fia_leveraged_fund.pdf

by transferring assets to an investor. That power only arose in cases where redemption requests were made at a time when the Fund was illiquid. The key element was that, to be eligible for transfer, any assets must have been held by the Fund and been available for distribution at the time the payment became due.

The Court examined the FILBCI shares distributed to the redeeming investors. It observed that the payment to those investors fell due on 15 September 2011 and, on that date, the Fund had not held any shares in FILBCI. In fact, FILBCI did not even exist at that point in time.

The Court also held that it was no answer to say that the assets transferred to FILBCI had been held by the Ultimate Master Fund at the time the payment to the redeeming investors fell due. The Fund's offering documents made no mention of the existence of the Ultimate Master Fund and did not provide a power to distribute assets held by that fund.

Accordingly, the Court of Appeal held that it had not been open to the Fund to seek to satisfy its obligations to the redeeming investors by transferring the FILBCI shares to them. This alone was a sufficient basis on which to dismiss the appeal.

Valuation of distributed assets

Notwithstanding its findings on the first issue, the Court of Appeal went on to determine whether the Fund's directors could rely on their own valuation of the FILBCI shares on 13 February 2012 as providing sufficient value to discharge the debts owed by the Fund to the redeeming investors.

The Court's principal finding was that notwithstanding the Fund's articles and offering documents, its directors did not have a complete discretion to value the Fund and its assets (including the FILBCI shares) in any manner they saw fit. Instead, when valuing these assets, they were bound to exercise their discretion honestly, genuinely and in good faith, and not in an arbitrary, capricious, perverse or irrational manner.

Having made this finding, the Court of Appeal held that there was no evidence that the directors' valuation of the FILBCI shares carried out at their 11:55pm meeting on 13 February 2012 was the product of rational thought, required to satisfy their obligations to exercise their discretion properly. This conclusion was informed by the following facts:

- there was no evidence that the directors had ever applied their minds to what the proper valuation of the FILBCI shares should be;
- the only formal valuation obtained by the Fund was not produced until 27 February 2012, a full 14 days after the directors' determination; and
- the directors had not considered the potential impact of the reverse stock-split relating to the bank's shares, which might have had a material impact on the value of the Option held by FILBCI.

Therefore, the Court held that in any event, the Fund had not acted within its powers when making the *in specie* distribution.

Commentary

For fund professionals, the most important message to take away from this judgment is that the Court of Appeal confirmed that a fund's power to make *in specie* distributions would be determined by it articles and offering documents.

However, that does not mean that all powers will necessarily be upheld. In FIA, the Court of Appeal noted that an investor's interests might be prejudiced if a fund he invested into had the power to distribute assets to him which it had only acquired after he had ceased to be an investor in that fund.

On that basis, it would be interesting to see how the Cayman courts would react to a case where a fund's articles and offering documents are clear and provide it with such a power. Will the Cayman courts uphold the bargain made between the fund and its investors by upholding the fund's powers, or will they instead seek to protect investors by ruling that such a power would be so prejudicial to them that it should not be upheld?

Many master-feeder structures are likely to take the middle ground hinted at by the Court of Appeal. A fund's articles and offering documents may provide it with the power to make *in specie* distributions of assets held by its master fund at the date that any redemption payment falls due. Such a

power would appear less likely to prejudice redeeming investors and consequently more likely to be upheld by the courts.

Conclusion

This judgment highlights the complexity of the issues surrounding *in specie* distributions. It also demonstrates the potentially calamitous consequences for investment funds that fail to deal with this area properly. Directors need to consider such matters very carefully and take professional advice in relation to them.

Contacts:

Peter Hayden, Partner, Cayman Islands
+1 345 814 9108
peter.hayden@mourantozannes.com

Nicholas Fox, Managing Associate, Cayman Islands
+1 284 852 9268
nicholas.fox@mourantozannes.com

Catherine Green, Senior Associate, Cayman Islands
+1 345 814 9115
catherine.green@mourantozannes.com