BRIEFING

The liquidation of hedge funds: an Achilles heel?

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Contacts:

Tim Richards
Senior Associate, Cayman Islands

Peter Hayden
Partner, Cayman Islands

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

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Most hedge funds do not give active consideration as to how they are to be liquidated in their constitutional documentation. Unfortunately this can have serious consequences for the fund. This risk was highlighted by the recent decision of the Cayman Grand Court in *Re Heriot African Trade Finance Limited* (FSD no. 87 of 2010 unreported 4 January 2011 ("Heriot")). In Heriot the key issue was whether the fund should be liquidated by its management or by official liquidators appointed by the Court. All but one of the major investors in the fund backed the existing fund manager as the party best placed to liquidate it and return value to investors. A single investor was unhappy about certain aspects of the fund's performance and petitioned to have the fund wound up. Although the judge "sympathised" with the majority investor view he granted the winding-up order.

Loss of substratum

The main legal issue in Heriot was the circumstances in which a fund can be said to have "lost its substratum". The underlying principle, based on established English authorities, is that where it has become impossible in a practical sense to carry on the business for which a company was established, it can be wound up on just and equitable grounds even though the petition is opposed by a substantial majority of shareholders. Mr Justice Jones has developed this principle in a number of recent judgments in the Cayman Grand Court. Most importantly he has defined the test for "loss of substratum" for open ended investment funds in the following terms (judgment paragraph 30, originally set out in *Re Belmont Asset Based Lending Ltd* (21 January 2010, unreported)):

"...it can be said that it is just and equitable to make a winding up order in respect of an open ended corporate mutual fund 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 representations contained in its offering document."

In deciding that these criteria had been met in the Heriot case, Mr Justice Jones placed weight on the fact that there was no directly applicable liquidation procedure set out in the fund's articles. Due to this he found that the winding down of the fund by its own management was not something which the participating shareholders should have anticipated in the ordinary course of the fund's business. Having made this finding he decided that it followed, almost automatically, that liquidators should be appointed by the court.

Diverging judicial views

Mr Justice Jones line of judgments runs contrary to contemporaneous decisions of Mr Justice Bannister in the Courts of the British Virgin Islands (the "BVI") (see for example *Aris Multi-Strategy Lending Fund Ltd -v- Quantek Opportunity Ltd* (15 December 2010, unreported). According to Mr Justice Bannister, a fund will not be wound up on "loss of substratum" grounds against the wishes of the majority, unless it can be shown that it is impossible, as opposed to impractical, for the business of the company to be carried on. In his judgment, simply because a fund seeks to wind down its affairs does not mean that it has ceased to carry on business or that it is impossible for it to carry on business and hence it cannot be said to have lost its substratum, even if the winding down of the fund is not expressly dealt with in its constitutional documents.

Since the jurisdiction to make just and equitable winding up orders is a general equitable jurisdiction based on English principles, the Courts should take a consistent approach to these issues. These divergent decisions have created a position where there is real uncertainty about an investor's ability to wind-up a fund seeking to liquidate its assets.

Difficulties appealing winding up orders

It would be desirable for the position to be clarified by the appellate courts (the final court of appeal for both BVI and Cayman is the Privy Council). Unfortunately, this appears unlikely in the short term because there are real practical difficulties for funds in appealing a winding-up order. The court will only grant a stay where a refusal to stay would operate so as to render a successful appeal nugatory (ie worthless). In Heriot an application to stay the winding-up order was made, but refused because it was not possible to persuade the judge that, absent a stay, the appeal would be rendered nugatory. It is very difficult to persuade a court that the appointment of liquidators will be so seriously detrimental to a fund's assets so as to render an appeal worthless. There is case law in both England and the Cayman Islands to the effect that, although the courts have the jurisdiction to grant the stay of a winding-up order in practice, a stay is hardly ever granted (see for example *Re A. & B.C. Chewing Gum Ltd* [1975] 1WLR 579). As a further disincentive to appeal, even if a winding-up order is stayed, it is likely that the court will also order that the fund provide security for the legal costs of the petitioning investor. If a stay is not obtained, it is in practice likely to be very difficult to unwind the position once the liquidator has been in office for many months.

Guidance for funds

Many new funds are now including express provisions allowing for the winding down of the fund's affairs by management. However, existing funds are unlikely to have such provisions in their constitutional documents. To mitigate the underlying risk, existing funds should review and consider amending, if necessary, their constitutional documents to allow a wind down by management. The Cayman Court has clearly stated on more than one occasion that the loss of substratum issue arises because shareholders in the relevant fund cannot be considered to have signed up to the investment manager of the fund winding down that fund if this is not covered by the fund's constitutional documents. Clearly if a fund's constitutional documents explicitly cover the point, there should be no question that a shareholder has not signed up to the investment manager of a particular fund winding down that fund. With careful drafting the "Achilles heel" which the Heriot case highlights may be avoided.

Contacts:

Tim Richards, Senior Associate, Cayman Islands
+1 345 814 9141
tim.richards@mourantozannes.com

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