Hedge Fund Law Report
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Nominees

Investing in Cayman Islands Hedge Funds Through a Nominee or Custodian: An Unforeseen Peril

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The advantages of investing in corporate or limited partnership hedge funds through a nominee or a custodian registered as a shareholder or a named limited partner[1] are well known. Principally, the investor retains anonymity or some other perceived business advantage. On the other hand, investing in corporate or limited partnership hedge funds through a nominee involves the risk of misappropriation by the nominee, ignoring of instructions or the loss of or delay in recovering dividends or redemption proceeds in the event of the insolvency of the nominee. These disadvantages may of course be avoided or minimised by careful selection of the nominee, and by close regard to the terms of the nominee agreement (although, typically, the nominee will have standard terms, departure from which will be difficult, if not impossible).

Proceedings Brought by Nominees

There is another area of potential disadvantage – the attitude of the nominee in relation to the bringing of proceedings as the registered shareholder or limited partner, either against the fund itself, or a third party, in the interests of the investor. This is rarely provided for in the terms of the nominee agreement,[2] and nominees are generally wary of embarking upon proceedings on behalf of the investor, without wide-ranging indemnities and discretions as to the conduct of the litigation which will be brought in its name. Even if the nominee is willing to embark upon litigation, it may take considerable time to negotiate the terms upon which it will do so, which will give rise to difficulty and delay in the case of proceedings which are urgent.

In the case of litigation other than the winding up proceedings brought against the fund (whether corporate or an exempted limited partnership) or a third party, it may be possible, for the investor itself to bring the proceedings if the nominee refuses to do so, by joining the nominee as a defendant to the proceedings. See "If a Hedge Fund Goes into Liquidation between the Time of an Investor's Subscription and Issuance of Fund Shares to that Investor, Who Owns the Money Paid for the Fund Shares?," Hedge Fund Law Report, Vol. 4, No. 19 (Jun. 8, 2011). In this regard, Cayman Islands law would follow English law, as summarised in *Hayim v Citibank* N.A. [1987] A.C. 730, in the following terms (at page 748):

> [the Authorities] demonstrate that a beneficiary has no cause of action against the third party, save in special circumstances which embrace a failure, excusable or inexcusable, by the trustee in the performance of the duty owed by the trustees to

> the beneficiary to protect the trust estate or to protect the interests of the beneficiary in the trust estate.

However, these "special circumstances" will not extend to conferring standing on an investor who invests through a nominee to bring winding up proceedings against the company (or the exempted limited partnership) in Cayman. The statutory provisions for the winding up of a Cayman Islands' corporate fund are contained in Part V of the Companies Law (2011 Revision), which are extended to limited partnerships by the Exempted Limited Partnerships Law (2011 Revision). By Section 94 of the Companies Law, those entitled to present a winding up petition are limited to the company, a creditor, a contributory or the Cayman Islands Monetary Authority. In the present context, it is only a contributory which is material; and a contributory means a registered shareholder of the company or partner of an exempted limited partnership. Under Cayman law, as under English law, a company has no duty to have any regard to trusts of its shares. See *Re Perkins ex p. Mexican Santa Barbara Mining Co.* [1890] 24 Q.B.D. 613 (CA)), followed in the Cayman Islands case of *Svanstrom v Jonasson* [1997] CILR 192 (Court of Appeal).[3] The rationale for this rule is that for a company to have regard to beneficial interests held for its registered shareholders would make the conduct of carrying on of its business extremely difficult, and the ultimate result would be anything but beneficial for those holding shares in the company (per Lord Coleridge CJ in *Re Perkins*). The beneficiary of a trust of a share is not a contributory of the company in which his trustee is a shareholder (*Hannoun v R Ltd* [2009] CILR 124), and accordingly it has no standing to bring a petition as a contributory. Similar principles apply to those investing in exempted limited partnership through a nominee.

Jurisdiction

The jurisdiction to wind up a company (or an exempted limited partnership) falls outside the "special circumstances" referred to in *Hayim v Citibank* (discussed above), because it presents different considerations, far wider than the ordinary case in which the beneficiary may be able to bring proceedings where his trustee fails to do so. For example, the existence of winding up proceedings may significantly damage the company; and when considering whether or not to wind up a company, the court must have regard to the interests of all the creditors if the company is insolvent, or all the contributories if the company is solvent. These, amongst other factors, were held in *Hannoun* to illustrate the distinct nature of winding up proceedings, which although being brought procedurally in the name of the petitioner alone, are in reality being brought in the interests of the creditors or the contributories as a whole. In *Hannoun*, the Judge (Henderson J) said "if the beneficiary of a bare trust whose existence and identity have not been disclosed to the corporate directors is permitted to step out of the shadows and seek the dissolution of the company in which he has an indirect interest, the law would be expanded undesirably."

It may be thought that a simple solution to this problem would be to transfer the shares out of the name of the nominee, into the name of the investor, thus leaving the investor (once registered by the company as a shareholder) to bring winding up proceedings in its own right as a contributory. However, unless the shares are partly paid, which will be rare, a contributory may not bring a winding up petition unless it has held the shares in its own name for six months prior to the presentation of a winding up petition. Thus, although in theory the investor may become the registered shareholder on the transfer of the shares from the nominee (which will bring into consideration questions of the discretion of the Articles, duty and willingness of the directors to register such a transfer), there will inevitably be a significant delay before the investor can place itself in a position to bring a petition, and a delay of six months may, in

practice, delay the remedy of winding up for so long as to render the remedy effectively nugatory.

The six month hurdle will also arise if there is a change of nominee within the six month period before the presentation of a winding up petition. The purpose of the hurdle is to place constraints upon vulture funds and on those buying shares, with a view to immediate asset stripping through the winding up process[4] – but this mischief does not arise on the change in registered shareholders between nominee and beneficiary, or between outgoing and incoming nominee. This hurdle will continue to cause problems in this area in Cayman until the legislation is amended to apply the six month rule to the beneficial ownership of the shares.

Practical Solution

The only practical solution, as things stand, is to ensure that in the nominee agreement, obligations are placed upon the nominee to take proceedings on behalf of the investor, on terms which are spelled out and agreed at the time the nominee agreement is entered into, so as to cut down the power of the nominee to decline to bring proceedings, or to insist upon terms which may be impracticable, or at the very least take a considerable time to negotiate and agree. In the absence of such terms, an underlying investor has no right to compel the nominee to institute winding up or any other type of proceedings (*Svanstrom*); and the right of the investor to bring proceedings, joining a reluctant nominee as defendant (expressly recognised in *Hannoun*), does not extend to winding up proceedings.

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[1] For convenience, both a nominee and a custodian are referred to in this article as "nominee."

[2] Absent such terms, the investor, under Cayman or English law, has no right to compel the nominee to bring proceedings. *Svanstrom v Jonasson* [1997] CILR 193 (Cayman Islands Court of Appeal).

[3] A specific provision within the fund's constitutional documents is generally also inserted to this effect. See "What Are the Legal and Practical Effects of a Discrepancy between the

Provisions of a Cayman Hedge Fund's Articles of Association and Offering Documentation?," Hedge Fund Law Report, Vol. 4, No. 15 (May 6, 2011).

[4] Companies (Amendment) Bill, 2007, Memorandum of Objects and Reasons.

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