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Fund Liquidations

Loss of Substratum: Analysis of the Conflicting Cayman Islands Standards (Part One of Two)

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In two recent winding-up petitions issued against investment funds on the just and equitable basis[1] – *Re Harbinger Class PE Holdings (Cayman) Ltd*[2] and *Re Washington Special Opportunity Fund, Inc.*[3] – the Financial Services Division of the Grand Court of the Cayman Islands has revisited the controversial question of the appropriate test winding up a company on the grounds of loss of substratum (*i.e.*, loss of the purpose for its existence). Considered in the context of earlier Cayman authorities on the test for loss of substratum,[4] the law is now in a considerable state of confusion and is therefore ripe for clarification by the Cayman Islands Court of Appeal – particularly because of its significance for Cayman's financial services industry.

This article, the first in a two-part series, describes the history of the Cayman Islands loss of substratum and the disparate current standards – the "impossibility test" and the "non-viability test" – being used by the courts. The second article will analyze how the impossibility test can be properly applied in the context of a fund proposing a soft wind-down, and how the potentially valid policy factors identified by courts concerning its usage can appropriately be addressed.

History of the Law on Loss of Substratum

In the spate of petitions brought in the Cayman Islands and the British Virgin Islands (BVI) following the 2007-2008 credit crunch, there was a very well-publicised divergence of view between that of Justice Jones in the Cayman Grand Court and Judge Bannister in the BVI Commercial Court.

In a series of cases beginning with *Belmont*, Justice Jones propounded a test of non-viability, concluding that where an open-end investment fund had suspended redemptions, following the receipt of a flurry of redemption requests, and then sought to implement a soft wind-down, the fund was no longer "viable," its substratum was lost and a winding-up order would be made appointing official liquidators to carry out the liquidation process in the normal way.

In BVI, the position reached was markedly different. In the case of *Aris Multi Strategy Lending Fund Ltd v. Quantek Opportunity Fund Ltd.*,[5] Judge Bannister expressly declined to adopt the non-viability test, preferring the traditional English law test of impossibility. He viewed a soft wind-down process performed by the fund itself as the fund continuing to carry on its business, rather than as proof that its business had ceased. See "British Virgin Islands High Court of

Justice Rules That Minority Shareholder in Feeder Hedge Fund That Had Permanently Suspended Redemptions Was Not Entitled to Appointment of a Liquidator" (Mar. 11, 2011).

In 2012, in *ABC Company (SPC) v. J & Company Ltd*,[6] the Cayman Islands Court of Appeal recognised this difference of view regarding the test for loss of substratum in Cayman and BVI law, but declined to resolve it. See "Cayman Court of Appeal Holds That Soft Wind-Down of One or More Segregated Portfolios of a Segregated Portfolio Company Does Not in and of Itself Justify a Judicial Winding-Up of the Entire Company" (Jun. 8, 2012). Justice of Appeal Chadwick specifically stated in *ABC* that:

> It must be anticipated that an appeal will come before this court in which it will be necessary to choose between the approach of [Judge Jones] in *Belmont* and *Heriot* on the one hand and [Judge Bannister] in *Aris* on the other hand, or, perhaps, to decide that the true approach in this jurisdiction should lie somewhere between the approaches respectively adopted in those cases. But this is not that appeal.[7]

Debate on these issues concluded at that (unresolved) point in 2012, until it was resurrected in the two recent cases of *Re Harbinger* and *Re Washington*. Both cases neatly highlight the continuing confusion in Cayman law as to the correct test for loss of substratum generally, as well as its proper application in the particular context of investment funds.

In *Harbinger*, Justice Clifford, after citing the Court of Appeal's comment in *ABC* above, also declined to choose between the two approaches. Justice Clifford justified this by explaining that "[b]y common consent the Company here is not, and never has been, an open ended corporate mutual fund . . . ."[8]

Having reviewed the traditional English case law establishing the impossibility test for loss of substratum earlier in the judgment, Justice Clifford concluded that:

> the test to be applied in this case in determining whether there has been a failure of substratum is founded upon the established underlying principle of the line of authorities referred to which requires the Court to determine whether it has become impossible for the company to achieve the purpose for which it was formed.[9]

In *Re Washington*, the court unsurprisingly found, in reliance on *ABC*, that an amendment to the fund's articles expressly specifying and authorising the wind-down process that was in fact undertaken meant that the reasonable expectations of shareholders were that the fund's business obviously included such a wind-down. Justice Mangatal also concluded that there was "no need in the circumstances of this case for me to have to examine the merits of the difference in views as to the loss of substratum test expressed by [Judge Bannister] in the BVI and [Judge Jones] in the Cayman Islands".[10]

Justice Mangatal went on to decide that, on the evidence before the Court, "neither on the *Belmont* line of authority, nor on the more traditional impossibility test, is there room for finding that this Fund has lost its substratum or that it is non-viable."[11]

Uncertain Standard for Loss of Substratum

In light of the above, it is hard to deny that the law regarding loss of substratum in the Cayman Islands is now in an unsatisfactory state, in particular as it applies to investment funds.

One view of the law, following *Harbinger*, is that there are currently two different tests in operation for loss of substratum: a test of "non-viability" for open-end funds and the "impossibility" test for all other companies. This cannot be appropriate as a matter of principle, and this uneasy accommodation is in direct conflict with earlier Grand Court authority that applied the *Belmont* test to a company that was not an open-end investment fund.[12]

Judges have often taken the view that both tests might represent the law and have presumably felt compelled by the existence of two tests in the case law to rely on both in their reasoning. This alternative approach – which signifies that all is not well with the law in this area – was adopted by Justice Mangatal in *Re Washington*,[13] by Justice Foster in *Freerider*,[14] by the Chief Justice in *FIA Leveraged Fund*[15] and arguably also by Judge Jones himself in *Re Heriot African*.[16]

For at least 138 years – between the English Court of Appeal judgments of Lord Cairns in *Re Suburban Hotel Company* (1867)[17] and of Lord Justices Andrew Longmore and David Lloyd Jones in *Tower Taxi v. Marsden* (2005)[18] – and as applied in 20 reported authorities,[19] the traditional common law test for loss of substratum applicable to all companies has been the impossibility test.[20]

Notwithstanding this long line of authority, however, other common law courts outside the Cayman Islands have also occasionally referred to non-viability,[21] and this test has also now been referenced in the most recent edition of the leading work in this area.[22] However, in the authors' view, for Cayman law to continue to adopt a different test in the face of such long-established authority, very strong justification on the grounds of principle or policy would be required. It is respectfully suggested below that no suitably strong justification exists.

Non-Viability Test Is Improper

The justification in *Belmont* for utilizing the non-viability test, rather than the impossibility test, was that it was questionable "whether it is sensible to adopt terminology invented in the context of England's 19th century economy." But the terms in which the impossibility test for loss of substratum has been stated from that time to the present are neither arcane, nor difficult to understand. As Lord Cairns stated the test in 1867 in *Re Suburban Hotel*, the question is simply whether "the business which the company was incorporated to carry on has become impossible".[23]

The traditional *Re Suburban* "impossibility" test had been applied in the Cayman Islands prior to *Belmont* without any difficulty in the then-recent case of *Re Indies Suites Limited*[24] and in England in *Tower Taxi* – neither of which were referred to by the court in *Belmont*.[25] Conversely, a test based on "non-viability"[26] is more difficult to understand, more uncertain in application and less stringent than a test based on impossibility.[27] It therefore makes a winding-up order and the appointment of liquidators easier to obtain, rather than merely restating in modern terms a test of an equivalent standard (as was seemingly intended).

Judge Jones expressly identified[28] the following policy justifications for adopting the less stringent non-viability test in the Cayman case of *Belmont*:

1. The skillset required of a successful investment manager is wholly different from that required of professional liquidators.
2. Investment management agreements are invariably made on the basis of the fund being a going concern and that the manager will be responsible for making investment decisions and

managing investments, such that the terms may be inappropriate to a situation where the fund is being liquidated.

3. Remuneration on the basis of a percentage of net asset value (NAV) coupled with a performance fee calculated as a percentage of realised gains will be inappropriate where the fund ceases to be viable and the investment manager ceases to perform at least some of the functions contemplated by the investment management agreement upon adopting a liquidation role.
4. If the principal and only function left for management is that of realising the company's assets for the benefit of creditors and shareholders, this may involve an investigation and pursuit of claims against the investment manager and other service providers which can only be undertaken by professional independent liquidators.
5. Even where there is no apparent cause for complaint against any of the fund's service providers, investors should not be deprived of the advantages of having professional liquidators undertake the task nor of the protections provided by the Cayman Island's Companies Winding Up Rules 2008 (as amended).

These are all potentially valid reasons for the appointment of liquidators in any given case. However, they do not universally apply to all situations in which an open-end fund suspends redemptions, such that they justify a change to the well-established common law test for loss of substratum, in particular where that change is then to be applied to all companies.

Even if the correct view is that the non-viability test applies only to investment funds, or only to open-ended investment funds, it has been clearly stated in Cayman Islands appellate cases relating to investment funds that establishing *a priori* Cayman law rules for all investment funds is inappropriate.[29] The same reasoning applies in this context.

It is therefore respectfully suggested that the proper Cayman law test for winding up any company, including all types of investment funds, on the grounds of loss of substratum, is the traditional test of impossibility.

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[1] Section 92(e) of the Cayman Islands Companies Law (2007 Revision).

[2] Unreported, 10 November 2015.

[3] Unreported, 1 March 2016.

[4] See the Cayman Grand Court decisions in *Re Belmont Asset Based Lending Ltd.* [2010] 1 CILR 83; *Re Wyser-Pratte Eurovalue Fund Ltd.* [2010] 2 CILR 194; *Re Heriot African Trade Finance Fund Ltd.* [2011] 1 CILR 1; and *In re Freerider* [2010] 1 CILR 486. See also the Cayman Islands Court of Appeal decisions in *In re Freerider* [2011] 2 CILR 103 and *ABC Company (SPC)*, [2012] 1 CILR 300.

[5] BVI Commercial Court, 15 December 2010.

[6] [2012] 1 CILR 300.

[7] The reason given for that conclusion was that ABC was an appeal from a decision on a strike out application on a petition to wind up an SPC when only a minority of its segregated portfolios

were subject to suspension of NAV and redemptions. *Id.* at [67].

[8] At [57] of the Judgment.

[9] *Id.* at [58].

[10] At [82] of the Judgment.

[11] *Id.* at [83].

[12] See the judgment of Justice Foster in *Freerider*, concerning a company which held the intellectual property rights to a self-propelling electric wheel, at [49] and [72] of the Judgment.

[13] At [83] of the Judgment.

[14] *In re Freerider*, [2010] 1 CILR at [71].

[15] Unreported, 18 April 2012, at [126-127]. This issue was not dealt with in the subsequent appeal. *Re FIA Leveraged Fund* [2013] 1 CILR 152.

[16] *Re Heriot African*, [2011] 1 CILR at [34].

[17] LR 2 Ch App 737.

[18] EWCA Civ 1503.

[19] *Re Suburban Hotel Co* (1867) LR 2 Ch App 737; *In re Diamond Fuel Co* (1879) 13 Ch D 400; *Re Haven Gold Mining* (1882); *Re Red Rock Gold Mining Co Ltd* (1889) 61 LT 785; *In re Crown Bank* (1890) 44 Ch D 634; *Re Bristol Joint Stock Bank* (1890) 44 Ch D 703; *Re The Varieties* [1893] 2 Ch 235; *In re Coolgardie Consolidated Gold Mines Ltd* (1897) 76 LT 269; *Re Amalgamated Syndicate* [1897] 2 Ch 600; *Re Palace Restaurants* (1909) 127 LT Jo 430; *Re Bleriot Manufacturing Aircraft Co Ltd* (1916) 32 TLR 253; *Re Baku Consolidated Oilfields Ltd* [1944] 1 All ER 24; *Re Taldua Rubber Co Ltd* [1946] 2 All ER 435; *Re Kitson and Co Ltd* [1946] 1 All ER 435; *Galbraith v. Merito Shipping Co Ltd* 1947 SC 446; *Re Eastern Telegraph Co Ltd* [1947] 2 All ER 104; *Re Tivoli Freeholds Ltd* [1972] VR 445; *Re JE Cade & Son Ltd* [1991] BCC 360; *Re Perfectair Holdings Ltd* [1989] 5 BCC 837; and *Tower Taxi v Marsden* [2005] EWCA Civ 1503.

It may be particularly noteworthy in understanding the position taken by Judge Bannister in the BVI that he appeared as leading counsel in *Re Perfectair* arguing in favour of management being permitted to continue litigation on the company's behalf, despite the company's trading activity having ceased. That case centered on whether the company's subsidiary should be sold pursuant to an agreement that this disposition occur in connection with the winding-up of the company. The court in *Re Perfectair* held that as the litigation was being prosecuted for the purposes of (an agreed) liquidation, and no trading activity was continuing, a winding-up was just and equitable on the ground of loss of substratum:

The directors were not put into office and cannot claim to be maintained in office for the purpose of liquidating the company. That is not the function of managers. That is the function of a liquidator. If all the shareholders of a company are content that the board of management should sell assets and prosecute actions not for the purpose of advancing any principal object but for the purpose of liquidating, so be it. There is nothing ultra vires in that. But the purpose, in my opinion, of the various powers and privileges conferred on managers is for the serving and furthering of the principal objects of the company of which they are directors and is not for the purpose of liquidating and winding up.

At [849] et seq.

[20] The then-recent application of the traditional impossibility test in the English Court of Appeal was not cited in any of the Cayman cases between 2010 and 2012, but was cited in Mr. Coverley Smith QC's submissions in *Aris* and then referred to in the Judgment of Judge Bannister in that case.

[21] *Macquarie University v. Macquarie University Students' Council Inc* [2007] NSWSC 510 ("[T]he plaintiffs have clearly established that the MUSC is no longer viable."); and *Ng Sing King v. PSA International Pte Ltd* [2005] SGHC 5 ("I believe that the company is no longer viable and it would thus be pointless for shareholders to continue flogging a dead horse."). None of the authorities referenced in this article (or indeed any authorities) were cited in either of these opinions on the loss of substratum issue.

[22] See French, *Applications to Wind Up Companies* (3rd edition, 2015, OUP, Oxford) at [8.262].

[23] The impossibility test has been alternatively stated as (1) whether the business has become "in a practical sense, impossible" (see *Diamond Fuel*); and (2) whether "that which the company has been formed to do can no longer be done" (see *Bristol Joint Stock Bank*). See French, *Applications to Wind Up Companies* at [8.260].

[24] [2004-05] CILR 498.

[25] As referred to in a note to the CILR report of the *Indies Suites* judgment, the case was successfully appealed on the basis that the petitioners did not have standing to petition based on their status as mere prospective creditors, which was insufficient for the purposes of the Companies Law as it then stood. Since that was sufficient to dispose of the appeal, the Cayman Islands Court of Appeal did not address the other aspects of the Chief Justice's Judgment, including his application of the traditional impossibility test for loss of substratum. See p. 9 of the Judgment of Forte JA in Civil Appeal 22/05, *sub nom Brac Construction Ltd v. Broome and Broome* (27 April 2006).

[26] This phrase may have originated from the admission in the evidence before the Court in *Belmont* that the directors had deemed the continued operation of the fund as being "no longer viable", as reported in a letter from the fund's administrators. *Belmont*, [2010] 1 CILR at [6-7].

[27] The following Judge Jones description of the reformulated test in *Belmont* highlights the fact it is a less exacting standard than the traditional impossibility test: "[I]f 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." *Id.* at [12].

[28] Contrary to the suggestion of Judge Bannister in *Aris* that Judge Jones "did not explicitly identify the nature of such policy reasons in the course of his judgment" in *Belmont*. BVI Commercial Court, 15 December 2010 at [31].

[29] This stance was determined by the Privy Counsel in *Culross Global Limited v Strategic Turnaround Master Partnership* [2010] UKPC 33 at [16], and by the Court of Appeal in *Ekstrom v Weavering Macro Fixed Income Fund Limited* [2015] 1 CILR 45 at [105-106].

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