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Fund Governance

How Funds Formed in the Cayman Islands Can Mitigate Legal Risk by Aligning Their Constitutional Documents and Operations

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In the recent *Ardon Maroon*[1] case, the Cayman Court followed a strict literal interpretation of a fund's constitutional documents – even where that interpretation ran contrary to market practice. Although the case is under appeal, the strict approach to the construction of constitutional documents by the Cayman courts is well established. This approach creates legal risk wherever there is a mismatch between a fund's constitutional documents and its operations. This article reviews the relevant cases and highlights six steps that market participants can take to manage that legal risk.

For more on issues pertaining to the Cayman Islands, see "How Fund Managers Can Navigate the E.U. General Data Protection Regulation and the Cayman Islands Data Protection Law" (Aug. 9, 2018); and "In Madoff-Related Litigation, Cayman Court of Appeal Holds That a Liquidator May Not Adjust a Shareholder's NAV, Even When Based on Fictitious Profits" (May 17, 2018).

Ardon Maroon – Back-to-Back Master/Feeder Redemption Notices

The *Ardon Maroon* case considered whether a fund's constitutional documents meant that it was necessary for a feeder fund to serve a separate, back-to-back redemption notice at the master-fund level.

Background

The Ardon Maroon Asia Dragon Feeder Fund (the FF) was a feeder fund to the Ardon Maroon Asia Master Fund Limited (the MF, and together with the FF, the Funds). The same individuals served as directors of the FF and the MF, and both Funds appointed the same investment manager, administrator and transfer agent.

On 11 August 2014, an investor in the FF submitted a redemption notice. The FF did not retain any assets other than its shareholding in the MF and looked to the MF to satisfy the redemption request. No redemption notice, however, was submitted to the MF.

The MF's assets were illiquid and could not immediately be realised to meet the redemption request. As a result, on 30 October 2014, the directors of the Funds resolved to suspend redemptions and payment of redemption proceeds from both Funds. On 30 December 2014, the Funds passed special resolutions that they should be wound up voluntarily and that liquidators be appointed.

The investor submitted a proof of debt, which was ultimately accepted by the FF's liquidators. The FF's liquidators submitted a proof of debt, which was rejected by the MF's liquidators on the basis that no redemption notice had been submitted to the MF. The FF's liquidators appealed to the Cayman Court.

The FF's private placement memorandum stated that the redemption procedure for the MF was to be identical to the FF's procedure. In addition, the MF's articles of association (Articles) contained what appeared to be a general power for the directors to issue shares that could be redeemed on such terms as they determined. The Articles, however, also contained detailed provisions setting out the redemption procedure. These redemption provisions included a specific power for the directors to waive or reduce the notice period for a redemption notice – but did not refer to doing away with a redemption notice entirely.

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For more on master-feeder structures, see "Beyond the Master-Feeder: Managing Liquidity Demands in More Flexible Fund Structures" (May 25, 2017); and "FCA Amends Its Position on Annex IV Reporting: U.K. and Non-EEA Managers, Including U.S. Managers, Must Now Report Holdings at Master Fund Level" (Apr. 13, 2017).

The Court's Interpretation

The FF argued that the general power to issue shares in the Articles gave the directors unrestricted power to issue shares and determine the rights attached to those shares. Moreover, the FF argued that the directors had exercised that power to issue shares, which automatically redeemed at the MF level as soon as a redemption notice was given at the FF level, without the need for a separate MF redemption notice to be given. This position was supported by expert evidence that such automatic redemption is a near-universal market practice, as a back-to-back process is essential to avoid a mismatch in liquidity profiles.

The Court did not, however, interpret the general power as being separate and standalone. As a result, the Court, perhaps surprisingly, considered that the general power had to be interpreted in the light of the specific power. The Court, therefore, concluded that it would have been illogical for the Articles to set out a detailed redemption procedure and then confer a general power which would allow the directors to disregard that procedure entirely. Accordingly, the Court found that the proper construction of the Articles was that the directors did not have the power to dispense with the requirement for a redemption notice.

The Court went on to consider the issue of waiver. The Court found that, given its construction of the Articles, the requirement for a redemption notice was not capable of being waived and that, in any event, the directors had not made an unequivocal representation of waiver.

Market participants may be surprised by this outcome given the near universal practice of back-to-back redemptions at the master-fund level when a redemption notice is given at the feeder-fund level. The Court noted, however, that, while there was no legal barrier to a back-to-back process, its function was not to pass judgment on general practice, but to assess the proper construction of the documents in this specific case. On that basis, the Court found that the provisions in the MF Articles setting out the redemption procedure – including the need for a redemption notice – had to be followed.

Relevant Case Law

The case is under appeal, and a different outcome may ultimately be reached. Nevertheless, the general approach of strictly interpreting issues of construction in a fund's constitutional documents is well established in the Cayman Islands and has been followed in many cases.

In *Strategic Turnaround*,[2] the Privy Council (Board) considered whether the redemption process set out in a fund's articles should take priority over the process set out in a confidential explanatory memorandum (CEM). Strategic Turnaround was a regulated mutual fund. An investor in the fund, Culross SPC Ltd., submitted a redemption notice.

Following the agreed redemption date, however, the fund suspended all redemptions and refused to pay the investor the redemption proceeds. The investor presented a winding-up petition upon the basis that the fund could not pay its debts. The fund applied to have the petition struck out, arguing that the proper redemption process had been followed and, as a result, the investor was not a creditor and had no standing to present the petition.

The fund's Articles contained a power for the directors to suspend the redemption of shares. The CEM stated, in addition, that the directors could suspend payment of redemption proceeds. The fund relied on the CEM in asserting a power to suspend payment of redemption proceeds after the redemption date.

In light of the CEM, the Cayman Islands Court of Appeal (CICA) considered redemption to be a process, not a single event. As a result, the CICA construed the Articles as being consistent with the CEM by interpreting the reference to redemption as including the payment of redemption proceeds. The effect of this decision was that the fund had properly suspended payment of the redemption proceeds and that the investor, as a mere prospective creditor, lacked standing to wind up the fund.

The Board overturned the CICA decision. While redemption might be a continuing process, the Board considered that it did not follow that redemption did not take place until the end of that process. As the Articles contained no clear power to suspend payments after the redemption date, the Board held that the suspension could only be effective up to the redemption date. The payment of redemption proceeds was a separate procedure and the Articles contained no power to suspend that procedure. The Board held that the Articles and the CEM were inconsistent and that the fund was seeking to exercise powers that went beyond its Articles.

See "*Strategic Turnaround* Judgment Provides Welcome Guidance for the Hedge Fund Industry on the Suspension of Redemptions" (Jan. 21, 2011).

In *Medley Opportunity*,[3] the Court considered whether a side letter entered into by a beneficial owner could be enforced by a registered shareholder nominee. An investor, Fintan, entered into a side letter that provided that all redemptions it received were to be paid in cash and that any redemption suspensions would not apply to it for a period of more than 12 months. Having entered into the side letter, the investor made its investment through a nominee company.

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Following the onset of the financial crisis, the fund was restructured and the nominee entered into restructuring agreements varying the terms of its investment. The investor subsequently became unhappy with the progress of the restructuring and sought to enforce the side letter on its nominee's behalf and to claim that it was not bound by the restructuring agreements.

The Court held that, where a side letter is entered into between a fund and a beneficial owner who is not a registered shareholder, the side letter will be unenforceable. The Court rejected the suggestion that the investor and nominee should be treated as essentially the same and that an estoppel by convention had arisen merely because some parties treated the two as the same.

Indeed, the Court noted that one of the main reasons for the use of nominees was to ensure a separation between two distinct legal entities. The Court also held that the investor was bound by the restructuring agreements as the variation of the redemption provisions fell within the fund's powers under the Articles. The restructuring agreements were therefore enforceable, and the investor could not avoid the actions taken by its nominee.

See "Cayman Grand Court Decision Demonstrates the Practical and Legal Challenges of Investing in Hedge Funds Through Nominees" (Jul. 26, 2012).

In *Lancelot Investors Fund Limited*,[4] the CICA considered whether an investment manager had authority to enter into a side agreement on behalf of a fund. KBC Investments Limited invested in shares in the Lancelot Investors Fund held through its custodian, Fortis. The shares were subject to a lengthy lock-up period set out in the confidential information memorandum (CIM). The investor entered into a side letter that aimed to replace the lock-up agreement in the CIM with a right to redeem at any time but subject to a reducing percentage penalty. The side letter was executed by the investment manager on behalf of the fund.

In due course, the custodian submitted a redemption notice that was rejected on the basis that the side letter was not effective, and the lock-up period therefore applied.

Subsequently, the fund entered into liquidation. The custodian filed a proof of debt, but this was rejected on the basis that the side letter was ineffective as it lacked capacity on both sides – the investment manager did not have authority to bind the fund and custodian could not enforce the side letter entered into by the investor. The investor challenged the rejection.

At first instance, the Court found that:

1. the rights in the side letter that would attach to shares could only be enforced by the registered owner of the shares; and
2. the investment manager did not have authority to bind the fund and, therefore, lacked capacity to enter into the side letter.

In respect of the enforcement issue, the CICA stated that it was clear that, in ordinary circumstances, the rights attaching to shares can only be pursued by the registered shareholder. At the point that the fund went into liquidation and the custodian submitted its proof of debt, however, its claim became a right to receive a dividend rather than a shareholder claim and, as such, could be assigned to the investor. Therefore, the CICA found that KBC was entitled to maintain its claim as equitable assignee and had standing to appeal the rejection of the proof.

In respect of the capacity issue, the CIM noted that the investment manager was responsible for all the day-to-day affairs of the fund. The investor, therefore, argued that the investment manager had ostensible authority to enter into a side letter. The CICA considered that the CIM had to be interpreted in the light of the Articles, which provided that any variation of redemption terms could only be determined by the directors. The CICA, therefore, held that the scope of the investment manger's ostensible authority could not extend to varying the redemption terms. Accordingly, the side letter was not binding for lack of capacity.

See "Can an Investor Who Invests Through a Nominee Shareholder in a Cayman Islands Hedge Fund Rely on a Side Letter to Which Its Nominee Is Not a Party?" (Oct. 11, 2013).

Primacy of Constitutional Documents

The above cases are linked by the primacy given by the Cayman courts to a fund's constitutional documents. The fund's constitutional documents – its memorandum of association and Articles – form a statutory contract between the fund and its shareholders, and they are the framework under which the fund comes into being.

As a result, the Cayman courts have construed other agreements entered into by the fund against the backdrop of a strict interpretation of the Articles so as to reach a construction that is not inconsistent with the Articles. The courts have followed this approach even where it has given rise to an outcome which is not consistent with market practice.

At times, the approach of privileging the Articles has also acted as a quasi-regulatory tool to address situations where shareholders might be prejudiced by the actions of a fund. For example, the restrictive approach taken to side letters manages the possibility that a side letter might create a new class of shares that could potentially prejudice existing shareholders.

Nevertheless, the approach does mean that, wherever there is a mismatch between the constitutional documents and the way in which a fund operates, there is legal risk for market participants. The *Ardon Maroon* case is a further reminder to market participants of that risk and the need to manage it.
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Managing Legal Risk

In order to manage the legal risk, market participants – on both the fund and investor side – should ask themselves whether a fund's constitutional documents are consistent with the way it operates. If the two are inconsistent, they should consider which should be varied to bring them into alignment.

If the Articles have not been updated for a number of years, it is more likely that they will contain proscriptive provisions on the operation of the fund rather than leaving much to the directors' discretion. This in turn gives rise to a greater risk that they will be inconsistent with the actual operations of the fund. If this is the case, a general update of the Articles may be warranted.

Some common areas where inconsistencies may arise include:

1. *Subscription, Redemption and Conversion Processes*: Are these processes described in detail in the constitutional documents and correctly reflected in the offering documents and in practice? Are cut-off times, deadlines, notice periods and procedures being adhered to? Even subscription forms should be checked to ensure that the administrator or registrar and transfer agent are using the correct and most up to date versions. If there are exceptions, these need to be reported, with explanation, to the board either periodically for ratification or more immediately for any material variations.
2. *Director and Officer Appointments*: Have all directors and officers been properly appointed, and are any conflicts being adequately disclosed in the resolutions of the board in accordance with the constitutional documents? Is there an advisory board contemplated by the constitutional documents, and is it correctly constituted and acting appropriately?
3. *Net Asset Value (NAV) Calculations*: Are these being carried out correctly and consistently and to the correct number of decimal places? Are the administrator's or calculation agent's practices and procedures consistent with the provisions of the constitutional documents particularly as regards valuation policies? For example, is a bid or mid-market price prescribed in the constitutional documents while a fair value pricing is being used in practice? Misstated NAV calculations can cause serious problems for funds, and mistakes may be compounded if they remain unchecked over time.
4. *Dividend Calculations and Payments*: Are share classes accumulating or income shares? Are the correct policies and procedures being applied to the relevant share classes consistently and correctly? For example, are deadlines, notice periods and procedures being adhered to? Further, treating some but not all shareholders of the same class differently or, conversely, aggregating separate classes as if they are the same without proper authority in the constitutional documents can give rise to significant risks of exposing the fund to claims for any resultant losses.
5. *Side Letters*: Are side letters binding and enforceable? Consider whether they are consistent with the constitutional documents; are being entered into with proper authority and capacity for the fund and for the investor; and purport to vary fundamental share rights within a class as opposed to permitted matters where there is typically discretion to vary (such as fees, liquidity or information).
6. *Amendments Generally*: Are amendments in the offering documents being correctly processed and do they have any knock-on consequences or implications in the constitutional documents? For example, are the changes non-material or of benefit to investors as a whole? Or are they material or adverse to some but not all? Are adjustments being made which actually constitute a variation of share rights or, if not, would otherwise constitute a change in the representations made to investors at the time they invested? If so, failure to address such issues could give rise to significant risks of exposing the fund to claims for any resultant losses.

See our two-part series "HFLR and Seward & Kissel Webinar Explores Key Side Letter Terms": Part One (Nov. 16, 2017); and Part Two (Nov. 30, 2017).

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[1] *Re Ardon Maroon Asia Master Fund* (In Official Liquidation), unreported 17 July 2018.

[2] *Culross Global SPC Limited v. Strategic Turnaround Master Fund Partnership, Limited* [2010 (2) CILR 364]

[3] *Medley Opportunity Fund, Ltd. v. Fintan Master Fund, Limited & Nautical Nominees* [2012 (1) CILR 360]

[4] *Lancelot Investment Fund Limited* (In Official Liquidation); *KBC Investments Limited v. Varga* (As Official Liquidator) [2015 (1) CILR 328]

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