GUIDE

Investor protection in Cayman hedge funds: The 'just and equitable' winding up jurisdiction

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Introduction

It is well known that a high proportion of hedge funds are incorporated in the Cayman Islands, with 10,291 regulated funds based in Cayman as at September 2008 (Cayman Islands Monetary Authority Statistics). As the economic environment has deteriorated since August 2007, there has been much speculation about the impact on hedge funds of the so-called 'credit crunch' and the large falls in the value of securities and other assets. Some funds have already failed and observers have suggested that many more may fail. Whilst there is currently little evidence of such widespread failure, it is clear that a growing number of investors are considering their options, often because redemptions may have been suspended and they are interested in finding an exit from the investment or because they wish to take action to recover losses against those they believe to be responsible for causing them.

The typical hedge fund structure tends to restrict the ability of investors to take action by placing shareholder control in the hands of the investment manager. Investors often hold non-voting shares, with all the voting shares being held by the investment manager. All management functions are usually delegated to the investment manager. The investment manager will, therefore, usually have control of the fund and investors may feel powerless to take any action themselves.

The Rule in *Foss v Harbottle* (1843) 67 ER 189, which limits the circumstances in which a shareholder may bring a derivative action on behalf of the company or a personal action to claim loss which is reflective of loss suffered by the company, further restricts the ability of investors to take action themselves.

'Just and equitable' winding up

Against this background, the possibility of seeking a winding up on the just and equitable ground may have considerable appeal because it may allow investors to obtain an element of control, as well as the reassurance that matters will be dealt with by a truly independent professional liquidator. Concerns relating to the timing of any sale of the assets need not rule out a just and equitable winding up, since the liquidator may take such issues into account and, in appropriate cases, may even re-engage the investment manager to continue managing the assets so far as may be necessary for the beneficial winding up of the fund. In this event, the liquidator can provide more effective supervision of the activities of the investment manager than may otherwise be the case. Investors who have concerns that they feel are not being addressed may, therefore, wish to give serious consideration to the possibility of seeking a winding up order based on the just and equitable ground, which has long been seen as an important means of shareholder protection and of control over the management of companies.

Although in some jurisdictions, notably England and Wales, the relevance of the just and equitable winding up jurisdiction has been reduced by the availability of other remedies, such as that contained in section 459 of the Companies Act 1985, the Cayman Islands have not sought to introduce alternative remedies. As a result, the ability of the Grand Court of the Cayman Islands (the **Grand Court**) to make a winding up order is not limited by the types of restrictions placed on the English Courts to make an equivalent order (eg in section 122 of the Insolvency Act 1986 and see the comments of Jonathan Parker J *In re Guidezone* [2001] BCC 692). Section 94(d) of the Cayman Islands' Companies Law (2007 Revision) simply provides a power to make a winding up order if the Court is of the opinion that it is just and equitable that the company should be wound up. The Grand Court is guided by the English and other common law authorities but has interpreted its jurisdiction widely and sought to be flexible in the approach taken in respect of such petitions. It has, however, also been prepared to refuse to make winding up orders where other more appropriate remedies have been available, such as in circumstances where a fair offer has been made to purchase the petitioner's shares (see *In the matter of CVC/Opportunity Equity Partners Limited* 2002 CILR 77, where the Privy Council, upholding the decision of the Cayman Islands' Court of Appeal, indicated that a petition would not be allowed to proceed where a fair offer had been made to purchase the petitioner's shares).

Practical difficulties

A difficulty that may arise in this area stems from the jurisprudence not yet having caught up with developments in practice. Company law tends to assume a traditional view of the company where the authority to manage the company's business is delegated to directors, with shareholders retaining ultimate control, including the ability to remove directors by ordinary resolution. As noted above, this traditional view does not reflect the reality of the typical hedge fund structure, where the investment manager usually has control of the fund and cannot be easily removed, either by the independent directors or by the investors. The investment manager's duties are essentially contractual duties derived from its contract with the fund, and the extent to which the investment manager may be subject to the types of duties directors typically have is uncertain. Likewise, the scope of the duties owed by the independent directors may be affected by the extent to which authority has been delegated to the investment manager. The potential remedies available in respect of a breach of these duties may also be uncertain. One advantage of seeking a winding up based on the just and equitable ground is that an independent liquidator can be appointed to take over control of the company and investigate matters. Since the liquidator acts on behalf of the company, the Rule in *Foss v Harbottle* does not restrict his ability to take action if necessary.

Grounds for winding up

In the Cayman Islands, as in most Commonwealth jurisdictions, the starting point for determining whether or not the court should order a winding up on the just and equitable ground is the judgment of Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360. Lord Wilberforce criticised the tendency to create categories and headings under which cases must be brought but accepted that illustrations may be used and the sorts of circumstances in which the courts have been prepared to make winding up orders on the just and equitable ground are readily apparent from the authorities. The principal circumstances which are likely to be relevant in a hedge fund context are a breach of the 'legal bargain', a loss of the substratum of the fund and misconduct by management.

- Breach of 'legal bargain': It is well established that a winding up order may be made if there has been a breach of the 'legal bargain', as set out in the Articles of Association, any supplemental shareholders' agreement or any material statutory provisions (see *re A&BC Chewing Gum* [1975] 1 WLR 579). However, the difficulty referred to above in respect of the gap between the jurisprudence and current practice arises in this context. In the hedge fund context, investors tend to rely on the Offering Memorandum rather than the Articles of Association or any shareholders' agreement. In addition, the material statutory provisions deal with directors, rather than with a third party retained on a contractual basis to manage the business such as an investment manager. These matters have not yet been tested in the courts, but there seems to be no good reason for the court to refuse to intervene on the just and equitable ground simply because of the structure of the fund. This is particularly important in circumstances where the Rule in *Foss v Harbottle* may otherwise deprive investors of an effective remedy.
- Loss of Substratum: The Grand Court has previously held that, where the substratum of the fund had gone, the petitioners were entitled to a winding up order, even if it were contrary to the wishes of the majority of shareholders or creditors (see *In the matter of Philadelphia Alternative Asset Fund Limited* 2006 CILR N-7, applying *In re J.D. Swain Ltd* [1965] 1 WLR 909 and *In re Haven Gold Mining Co.* (1882) 20 Ch D 151). A total loss of assets will undoubtedly justify a finding that the substratum has gone (as *In re Philadelphia Alternative Asset Fund Limited*). It has also been held that an order should be made where the main objects for which the company has been formed have become impractical (see *In the*

matter of Paradigm Holdings Limited 2004-05 CILR 542, where a failure to comply with regulatory requirements prevented the company from trading) or where it has become impossible for the business to be carried on, even if it is not insolvent (see *In the matter of Indies Suites Limited* 2004-05 CILR 498). Although they have not yet been tested, it is possible to conceive of various possible arguments that could be raised in a hedge fund context to support a claim that a fund has lost its substratum. For example, if a fund was intended to be a leveraged fund but the 'credit crunch' has adversely affected the fund's ability to raise finance to leverage its investments, it may be possible to argue that the fund has lost its substratum. A similar argument could be made in relation to any circumstances, including suffering substantial losses, which adversely impact on the ability of the fund to meet its objects as set out in the Offering Memorandum or elsewhere.

- Misconduct by management: Misconduct by management has also long been an accepted reason for making a winding up order on the just and equitable basis (see *Loch v John Blackwood Limited* [1924] AC 783 and RCB and *Six Others v Thai Asia Fund Limited* 1996 CILR 9). In *Loch v John Blackwood*, the Privy Council indicated that a lack of confidence in the directors could be sufficient basis for an order, provided that the lack of confidence rested on a lack of probity. It may be difficult to establish that an investment manager, unlike a director, owes any fiduciary duties due to the contractual basis of their retainer (see *Kelly v Cooper* [1993] AC 205, where the Privy Council approved the statement of Mason J in the Australian case of *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 to the effect that, in contractual situations, any fiduciary relationship must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them). However, in many cases, the misconduct alleged against the investment manager is in the nature of a breach of fiduciary duty, such as a failure to disclose an interest in a fund investment. Due to the wide discretion conferred on the court, this should not prevent a petition being brought on the just and equitable ground.

In the Cayman Islands' case of *re Paradigm Holdings Limited* 2004-05 CILR 542, Henderson J appeared to suggest that the requirement for a full investigation was in itself one of the traditional grounds for making a winding up order under the just and equitable ground. This proposition was based on commentary in Palmers Company Law and *re Peruvian Amazon Co. Ltd* (1913) 29 TLR 384. If correct, it would considerably widen the scope of the just and equitable ground, potentially allowing a petitioner to obtain a winding up order, even in the absence of any evidence to justify the entitlement. However, in the Paradigm case there was evidence of breaches of Cayman law by the management and the comments of Henderson J need to be read in that context. The case may really be no more than an example of a case involving misconduct by management.

Conclusion

The just and equitable ground is, therefore, a relatively wide jurisdiction, which may assist investors who are concerned that the objects of the Offering Memorandum are not being achieved, that it may be impractical to meet the objects or to carry on the business of the fund or that the investment manager (and possibly others, including the independent directors and auditors) may have been guilty of some type of misconduct or breach of duty. It is a remedy that investors should be aware of and on which they should obtain advice in appropriate circumstances. The possibility of a winding up petition being brought is also something of which the investment manager and the independent directors should be aware. It underlines the need to engage with investors to address their concerns since even an unjustified petition will have to be dealt with, incurring cost in terms of both management time and legal expense.

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