

## Offshore: Rules of the islands

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22 Jun 2010 | 05:59

*The rights of creditors versus investors have been thrust to the fore by the banking crisis. Harney Westwood & Riegels' Phillip Kite discusses some of the distressed fund cases that have recently been decided in the British Virgin Islands*

Bernard Madoff may have dominated the headlines in 2008, but those who invested in his company were by no means the only ones affected during the market turmoil of that period.

Now that the immediate crisis of liquidity and redemptions has passed, complex and novel issues surrounding investors' rights and fund structuring are making their way to court in popular hedge fund jurisdictions including the Cayman Islands and British Virgin Islands (BVI).

One of the most interesting and important areas of distressed funds litigation continues to be the creditor/investor debate. It can be very important for a party to allege that it is a creditor, especially in liquidation proceedings. There have been various cases in other offshore jurisdictions, but recently the BVI commercial court handed down an important decision on the status of a redeemed shareholder and the application of section 197 of the Insolvency Act 2003.

In summary, the redeemed shareholder was viewed as an unsecured creditor and, as such, able to apply for the liquidation of the company in which they were previously a shareholder and to rank alongside other third-party unsecured creditors.

The facts presented to the court involved a fund (Reserve) that operated daily redemptions which ceased following the collapse of Lehman Brothers on 15 September 2008. Western Union (WU), as one of Reserve's shareholders, had submitted redemption requests for its entire shareholding on 15 September 2008. These requests were received and acknowledged on the same day and Reserve announced the net asset value at \$1 (70p) per share for that day. Redemptions were subsequently suspended. The redemption proceeds were not paid and WU petitioned as a creditor to wind up Reserve.

Reserve defended and denied that WU had completed the redemption of its shares, denied that WU was a creditor of the fund by virtue of section 197 and argued that, even if WU was a creditor, the court should exercise its discretion against appointing liquidators.



## **The scope of the redemption process**

On the first issue raised by Reserve, the court held that the question of whether or not the redemption process had been completed fell to be determined by an analysis of Reserve's articles rather than as an independent question of fact. The court examined the provisions of the articles that dealt with the redemption of shares and reached the conclusion that, if a redemption request was received by Reserve before 5pm eastern time on a dealing day, the shares referred to in that request were redeemed on the day of receipt.

The court also examined the provisions of the articles when reaching a conclusion as to whether or not Reserve had a power to suspend the payment of redemption monies. The court concluded that there was no such power, but noted that nor was there a specific date by which Reserve was obliged to remit the redemption proceeds.

## **Effect on the status of a redeeming shareholder**

In relation to the second issue raised by Reserve, the court highlighted the difference it saw between:

- a) a case involving a redemption that was still in progress, where the redeeming shareholder will continue to be and claim as a member and therefore section 197 will prevent him from claiming in competition with third-party creditors; and
- b) a case involving a redemption that had been completed, save for payment of redemption proceeds, in which case the redeeming shareholder will no longer be a member and will claim as a creditor. Therefore section 197 will not apply and he will be able to claim in competition with third-party creditors.

In this case the court found that, on its interpretation of the articles, the redemption had been completed and so WU was a creditor of Reserve.

## **Chapter 15 concerns**

On the third issue, Reserve suggested that it should not be wound up so that the parallel proceedings regarding the distribution of Reserve's assets in the US could continue. The foundation of this argument was that, in light of the recent decision in *re Bear Stearns High-Grade Structured Credit Strategies Master Fund Limited* 374 BR 122, the prospects of liquidators appointed in the BVI obtaining

recognition and assistance from the US bankruptcy court were negligible or worse.

The court rejected this argument, stating: "It seems to be of the highest importance that those who become creditors of, or who invest in, companies incorporated under the laws of the BVI, as well as those who finance them, should have complete confidence that if the company in question gets into difficulties, their rights will be determined in accordance with the law of this jurisdiction, and this confidence will be weakened if the perception is allowed to be gained that the courts here are prepared to decline or defer jurisdiction in insolvency matters in favour of foreign courts."

## **Analysis**

The statement by the BVI court that it will not stand by and allow foreign courts to determine insolvency proceedings regarding BVI companies will be welcomed by those who manage and invest in BVI companies, as they would expect a local company to be liquidated in accordance with BVI law and under the supervision of the BVI courts.

Any contrary indication would have risked undermining the certainty afforded to investors utilising BVI companies. In addition, there has been a recent successful application before the Delaware court for Chapter 15 recognition of a Cayman liquidation in the case of Saad Investments Finance Company (No.5) Ltd.

One critical point is that the court did not see section 197 as a bar to the liquidation application. Section 197 provides that: "a member, and a past member, of a company may not claim in the liquidation of the company for a sum due to him in his character as a member, whether by way of dividend, profits, redemption proceeds or otherwise, but such sum is to be taken into account for the purposes of the final adjustment of the rights of members and, if appropriate, past members between themselves".

The court held that this did not result in the subordination of claims and the critical issue was whether or not the redeeming shareholder's claim to the redemption proceeds was made in his character as a member. Following its reasoning above, the court held that because the redeeming shareholder was no longer a member, it could only claim as a creditor and therefore was not caught within the language of section 197. This reasoning is very different from the analysis of the Cayman court, in cases such as Strategic Turnaround.

However, the court will not always use a discretion to liquidate a BVI fund. For example, in *Citco Global v Y2K Finance*, a liquidation application was brought on two bases. First, on alleged improper redemption payments made by the fund prior to the suspension of redemptions, the court was of the view that it would not permit minority shareholders to wind up a company on the basis that they had, or might have, claims against its directors, as this would be inconsistent with the rule in *Foss v Harbottle* 2 Hare 461 [1843].

The second ground was based on a loss of substratum argument. By the time of the hearing the fund agreed that it should be wound up, but the directors wanted the opportunity to realise assets, repay investors and then enter into a voluntary liquidation procedure. Although the court preferred a wide definition of loss of substratum, it refused to make a compulsory winding up order as the directors were acting within the articles in making repayments, and any investor would have the more appropriate unfair prejudice remedy.

## **Conclusion**

The creditor/investor debate has been fought out in a number of jurisdictions and while each case can turn on its own facts and documentation, the BVI court has shown itself willing to enforce creditors' rights. Long may that continue.

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