

Timing is Everything

By Tim Clipstone

In the last three months of 2008, fund managers in many different sectors were forced into gating or suspending redemptions by the turmoil in the financial markets, restrictions on certain investment activities and the Lehman bankruptcy. As funds were forced to suspend or chose to pay redemption proceeds in specie or create side pockets, late December and the early months of 2009 saw fund of funds having liquidity issues, since they relied upon their underlying portfolio funds to give them liquidity. This in turn led to some significant pressure on relatively liquid funds which seem, in some cases, to have been used as ATM machines by their investors who were unable to realise cash elsewhere.

This general illiquidity, coupled with forced deleveraging and a rush for cash by investors, is causing a large number of funds to suspend redemptions, the calculation of NAV and payment of redemption proceeds. For many funds, the suspension is giving them time to restructure with a view to continuing trading. For others it is part of the process of an orderly wind down of the fund's activities.

Suspension better than cure

What has become clear is that, for the majority of funds, a suspension is least open to challenge when a suspension is determined upon prior to the relevant redemption date. Where a suspension is declared after the relevant redemption date, there is considerable uncertainty as to the effect of such suspension.

In all cases, the effect of such a suspension will be determined by the provisions of the constitutional documents of the fund. Some constitutions allow for the suspension to affect parts of the redemption process that have yet to be completed, such as the calculation of the NAV or the payment of redemption proceeds; in other cases it is not clear whether such a suspension is effective at all, especially where there is no separate right to suspend the NAV calculations or payments of redemptions.

Inevitably the imposition of suspensions have led to a number of cases coming before the courts.

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One of these cases, *Strategic Turnaround*, was recently heard by the Cayman Court of Appeal. The case considered the effect of a suspension imposed after the redemption date and the status of a redeemed investor. In summary, the court worked hard to view the investor as an unliquidated creditor from the redemption date but decided that redemption was a process and so did not have a problem with the concept that the NAV

calculation and obligation to pay could be suspended even though the process of redemption had commenced. In the court's view, redemption was a multi-stage process concluded by the payment of redemption proceeds and the removal of the redeemed shareholder's name from the register of members.

While litigation is rarely good news, this case provided some much needed guidance regarding redemptions.

Gating

Many modern funds already have gating provisions which restrict redemptions for any given redemption date, although these are commonly very broad provisions which take effect only when shares representing 10 – 20% or more of the fund's aggregate Net Asset Value are due to be redeemed. These mechanisms have proved to be very useful in managing outflows of cash from funds. Gates are fully disclosed in the offering terms and the imposition of a gate is usually seen as less damaging to the fund's credibility than a full suspension. While most gates deal with restricting redemptions on a fund or class basis, there is no reason why these could not be drafted more creatively to give funds more flexibility to restrict redemption payments, even on an individual investor basis. Since gates are generally fully disclosed in the offering terms, they can be used to manage investors' expectations for the return of their investments if the fund faces liquidity or other issues.

In kind payments

In many cases, whether they suspended before or after a redemption date, funds are deciding that it is better to resume redemption payments and pay as much cash as they can as soon as possible, rather than waiting for full liquidity to be restored. Where there is no adequate gating provision, many funds decide to rely on their ability to pay redemptions in part *in specie*, that is, by the transfer of assets of the fund to satisfy redemption proceeds. However, the transfer of underlying assets to a large number of investors is often restricted or practically very difficult to achieve and in many cases investors do not want to have to manage the assets themselves and would prefer the manager to continue to manage the asset realisation to maximise returns.

Synthetic side pockets

In response to the issues with paying redemption proceeds by the direct transfer of underlying assets to investors, a commonly used mechanism is to create a liquidating pool of assets and pay out cash as and when it is realised from the underlying assets. Where this possibility has been anticipated, it is common to find funds have provisions in their constitutions allowing them to convert ordinary shares into new restricted classes of shares which then represent the underlying illiquid asset pool (a classic side pocket).

Where a classic Side Pocket is not available, funds have looked to use other mechanisms to mirror the effect of the classic Side Pocket – these structures are often referred to as synthetic side pockets. Some funds have sought to create liquidating trusts of the illiquid assets and issue beneficial interests in those trusts to redeeming shareholders; others have sought to use the ability to pay redemption proceeds *in specie* by creating a wholly owned special purpose subsidiary to hold the illiquid assets (SPV), transferring the illiquid assets into the SPV in return for non-redeemable participating shares in the SPV (SPV shares) and transferring SPV Shares to satisfy redemption requests.

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The Bermudian courts were asked to consider in the *Gottex* case the concept of a liquidating trust as a form of synthetic side pocket and found on various grounds that the issue of interests in the trust was not a valid payment by the Company of redemption proceeds. However, while the court was not asked to consider the validity of the SPV route, the hedge funds industry has taken comfort from this case since all the objections seen as valid raised by the Bermudian court to the liquidating trust can be overcome when using an SPV.

However, even using an SPV there are some residual issues, the most important of which is that of valuation of the SPV Shares. This is because, once a redemption date is passed and an NAV is struck for that date, the redeeming shareholders are usually entitled to receive the redemption price in cash or assets equal in value to the redemption price. However, it is rare for the constitutional documents of the fund to identify how to value in kind payments. In the absence of express provisions, it may be safest to assume that the value of the assets on the date on which the in kind assets are transferred is the correct value to use for those assets, although this is far from definitive. The reason this is an issue is because, in most funds, the valuation date and the date on which the fund is ready to make redemption payments are not the same date. As such, if there is the possibility of price movements occurring in the assets held in the SPV, value differences could arise which, in a declining market, could lead to more assets being required to be put into the SPV to bring its value back up to the level required to meet the redemption price. This issue becomes particularly acute if the fund is winding down its business and could, in theory, lead to questions of solvency.

Lessons Learnt

Given the issues highlighted in the scenarios above, it is sensible for new funds to consider including some or all of the following in their constitutional documents:

1. An explicit ability to create classic Side Pockets for use when planned or unexpected illiquid positions arise;
2. An explicit ability to hold assets in a liquidating account to allow an internally managed process of realisation and phased payment to occur;

3. Provide for how and when to value assets to be used for *in specie* settlements of redemption proceeds;
4. Clarify the rights and status of shareholders who have redeemed shares but are awaiting redemption payments;
5. Clarify the effect of redemptions at each point in the process of redemption.
6. Include sophisticated gating mechanisms to allow directors to manage outflows without having to resort to suspensions or *in specie* payments.

Summary

Ultimately, what has become very clear over the last year is that funds which have sophisticated mechanisms already built into their constitutions to provide for gates and side pockets and those funds which recognise they have liquidity issues and suspend redemptions before they reach a critical redemption date are more likely to keep their investors happy and thereby avoid litigation and liquidation than funds which have to take emergency steps after a redemption date to limit or delay redemptions.

This article first appeared in *HFM Week's 2009 Cayman Islands Report*, published in April 2009. If you would like further information on the subjects discussed, please contact Tim Clipstone (tim.clipstone@harneys.com) at our Cayman Islands office or your usual Harney Westwood & Riegels lawyer. Alternatively, you may visit our website at www.harneys.com.

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