HARNEYS

Governance amidst disruption - a run on the fund?

“These days everyone has the same data regarding the present and the same ignorance regarding the future.”

Another particularly apt quote from Oaktree Capital’s Howard Marks, several weeks into lockdown and no closer to knowing where and how we, our families and our nations’ economies will find ourselves in a week, a month or a year.

In our last post we discussed some preliminary steps and considerations to be kept in mind by fund managers, operators and investors alike when facing times of economic uncertainty in their business and how simple steps such as regular and transparent communication may be the key to keeping the lights on. The on-going uncertainty serves only to confirm the likelihood there won’t be a “one size fits all” resolution across the board and all stakeholders should be prepared for any eventuality.

While we must remain optimistic that many investors, particular those who experienced the events caused by the last financial crisis of 2008, won’t act unduly hastily, it is undeniable that times of economic uncertainty typically lead to investors seeking to withdraw their investment for cash, regardless of the apparent stability of the fund. That said, one of the immediate consequences of the period after the last financial crisis was a significant review and improvement of terms found in fund documents with better, clearer and more focused protections and mechanisms in place to deal with uncertain financial times. An apparent run on redemptions or withdrawals can now, typically, be addressed with appropriate measures. We discuss below how managers, operators and investors can prepare for and deal with redemptions or withdrawals, whilst protecting themselves when things don’t go to plan. Offshore open-ended fund vehicles are, in the overwhelming majority of cases, established as companies. Of course, we also see unit trusts and limited partnerships. While this article refers to directors for ease, the principles will equally apply to trustees of unit trusts and general partners of limited partnerships.

Redemptions on the horizon - preparatory considerations

Understand your powers

If not already known, this is the opportune time for fund managers and directors to ensure, preferably with the benefit of legal advice, they have the necessary powers, investment terms, and disclosures in place to ensure they can protect the fund, investors’ capital, and protect themselves in the event things take an unexpected turn. We would expect discussions to have been held by now between fund boards and managers to address whether there are potential conflicts between directors and the manager or otherwise, ascertain the extent of experience any independent professional directors may have to help the fund navigate a distressed scenario, as well as deal with any other concerns of investors or other service providers. The form of these discussions could be formal or informal board meetings which are minuted or recorded appropriately. It is important that all appropriate corporate governance formalities are being met, not least as a matter of good practice but also in case of later litigation.

At a high level, managers will have been given the power of management of the fund’s assets through their service agreement, whilst directors will have the powers of overall governance of the actual fund entity. These governance powers will be set out in the fund’s constitutional document, the memorandum and articles of association. Summary disclosure of these powers will also be included in the relevant offering document as to how they might be exercised in practice. The articles usually allow directors to take steps for the protection of investors as a whole if the fund is facing liquidity issues. Such powers (to be discussed in more detail in the next section below) will tend to include the power to gate or suspend investor redemptions and perhaps even the power to establish side pockets to separate illiquid from liquid assets. The fund will also typically have the power to pay redemption proceeds in kind (rather than in cash), which may include the power to establish a new liquidating entity in order to do so.

Investors equally should take advice on their options of redemption (ie. is there a lock-up period (soft with redemptions penalties or hard with no options for redemption in the ordinary course) or are redemptions available on demand?) and understand the extent of the powers the manager and directors have under the fund’s documentation.

First mover advantage in a redemption scenario

Shrewd investors will be keeping a close eye on what's happening in the markets applicable to their relevant investment class; when they see red flags they often seek to get out of a fund.

When enough investors seek to use this "first-mover" advantage, the fund, depending on the nature of its investments, may be forced to sell assets to meet redemptions. In many cases (depending on the liquidity of the asset class or classes) the only way to dispose of them quickly can be to sell them at fire-sale prices; this often means the longer investors stay in the more they lose.

The Privy Council's decision in *Pearson v Primeo Fund*[1] confirmed that investors who have redeemed their investment prior to the date of commencement of a formal liquidation, even if the redemption proceeds have not been paid, will rank as creditors in the liquidation and will therefore be paid ahead of unredeemed investors, although their claims will rank behind those of ordinary creditors. From an investor's point of view, therefore, if a liquidation is on the cards, and it is still possible to do so (ie. the directors have not suspended voluntary redemptions), the early submission of a redemption request is critical in order to ensure priority in any distribution of assets.

But first… communicate

It can be difficult for a fund faced with a "distressed" scenario, to recover; unlike the prices of stocks or bonds that investors hold outright, funds, such as bond mutual funds, experiencing a run cannot salvage their position because the fund is forced to sell its assets and it will not therefore benefit from a later recovery. Provoking a forced sale in a dysfunctional market won't always be in the investors' interests either. For this reason and depending on the nature of the underlying investments, keeping channels of communication open is in all stakeholders' best interests.

We dealt in detail with this in our last post but it's worth repeating: it's never too late to communicate and investor relations should be made an absolute priority. Where possible, dialogue with investors can help to manage liquidity risk, particularly in the case of large investors whose redemptions could significantly affect the ability of the fund to meet redemption requests received or even to remain in operation. In the event that investors are considering making a redemption request, they should communicate as early as possible with their fund manager on key issues such as delays, acceptable slippage levels and other valuation issues and not seek to use redemption notices as a means by which to hold the fund to ransom. Communicating in advance of, as opposed to after, issuing redemption notices can avoid triggering disclosure clauses thereby leading to a run of redemptions by other investors.

Deployment of liquidity management tools

The efficacy of tools such as gates, side-pockets, and suspensions of NAV calculation and/or voluntary redemptions will depend on a number of different factors including the liquidity status of the fund and the profile of its investor base. Deployment of such measures should be done in a transparent and proportionate manner remembering to take into account the best interests of investors as a whole as opposed to the manager and directors themselves. We set out below a brief overview pointing to some of the most significant factors which should be borne in mind when implementing liquidity management tools.

Application of redemption gates

Redemption gates can be employed either at fund level or investor level with different thresholds and are typically used in order to slow down the rate of redemptions and to allow assets to be realised in a more orderly and controlled manner than might be the case if the fund were required to meet all redemption requests as and when received. Because of the fact that redemption gates restrict the investor's ability to access their redemption monies, managing reputational risk will be a key consideration for entities who decide to invoke this measure.

Temporary suspension of NAV calculation/ voluntary redemptions

Prior to 2008, suspensions were rare, the general view being that to invoke a suspension would cause irreparable reputational damage to a fund and/or manager. However, in the midst of the 2008 financial crisis, in many cases it was those funds that did suspend redemptions, waited for the storm to pass, limited the damage and then eventually lifted suspensions that were able best to manage the process.

The suspension of NAV calculations effectively means a suspension of voluntary redemptions. This is because until the NAV is calculated there is no ability to calculate an amount due to a redeemer. It may be considered necessary at a time like this on the basis that asset prices owing to market volatility have become so unpredictable as to render a fair valuation difficult or impossible.

In 2008, fund documents typically did not allow funds to selectively suspend redemptions without also suspending NAV calculation and vice versa. However, with the improvement in fund documentation since then, it will typically be possible to suspend voluntary redemptions without also requiring the NAV calculation to be suspended. Perhaps the most draconian of emergency liquidity management tools, a temporary suspension of voluntary redemptions in a fund can nonetheless be an effective way in which to stop any potential "run" of redemptions and to avoid having to accept heavily discounted values for the assets held within the portfolio, which in each case may well damage the long or short-

[1] [2017] UKPC 19

term interests of investors. This tool can allow managers to manage redemptions in an orderly manner and obtain a better price for underlying assets once pricing conditions stabilise or improve. It's worth bearing in mind that the power to suspend voluntary redemptions will not mean that a fund cannot, if it needs to, return cash to investors through compulsory redemptions, provided that assets can be valued.

Whether the choice is to suspend the calculation of the NAV or suspend redemptions, these tools should only be used in exceptional cases where the circumstances demonstrably require it, where the constitutional documents allow and where the suspension is justified having regard to the interests of all investors. Consider the interplay between the suspension and the fund's stated objectives, ie. if the fund was supposed to have comprised predominantly liquid investments, it will be difficult to demonstrate how a suspension was required due to illiquid investments and that this resulted from external factors as opposed to mismanagement. Stakeholders should make themselves aware of any provisions in the constitutional documents which may enable investors to remove the directors or manager if they disagree with the suspension and consideration should be given to whether management fees should be reduced, deferred or even waived in a "suspension scenario" or if payable, on what basis will they be calculated, particularly if NAV calculations have been suspended. Although discussed in the market post-2008, management agreements still do not generally contain provisions to allow fees to be calculated if NAV calculation is suspended.

In-kind redemptions

In-kind redemptions may also be used in order to manage the liquidity of a fund. This involves the fund satisfying a redemption request through the transfer of an underlying asset to a redeeming investor and avoids the need to sell the underlying assets or deplete cash reserves. Directors should be aware that such distributions need to be consistent with offering memoranda and the constitutional documents and cannot, usually, be dealt with in a way that suits the particular circumstances of the fund; for example, by creating a liquidating entity over which the investor has no control for which there is no contractual basis. That said, most funds created after 2008 will typically include provisions which will allow the fund to establish liquidating entities to address this scenario.

Side pockets

Another viable liquidity management tool available (where expressly provided for in the fund documentation) is the use of side pockets. This involves the creation of side pocket share classes into which assets which become illiquid or difficult to value after acquisition may be placed in return for which the investor receives shares in that side pocket class, thus avoiding the need to redeem less liquid assets at heavily discounted prices in order to meet redemption requests. While the remainder of an investor's shareholding can be redeemed in the normal manner as described in the fund's documentation, shares in the side pocket class cannot be redeemed by an investor until such time as the underlying assets become sufficiently liquid.

Understanding risks and pitfalls when faced with liquidity issues

Directors' duties

As an investor, it's important to understand what the directors of a fund can and can't do when the liquidity of the investment portfolio is such that it can't meet redemption requests. The directors owe fiduciary duties to act in the best interests of the company, which in the case of a solvent company means its shareholders as a whole (if the entity is insolvent, duties will be owed to the creditors as a whole). Under Cayman Islands law, the investment manager is simply a service provider to the fund and does not owe separate duties to the investors in the fund. Contrast this with countries such as the United States where a manager may also owe statutory duties to investors. Whatever liquidity management tools are deployed, it goes without saying that management must exercise its powers in accordance with its fiduciary duties, and any exercise which is not in accordance with those duties will be open to challenge.

In difficult times for the fund, the directors and manager may come under pressure to permit or prioritise the redemption of one investor over another. This issue was given high profile consideration in the case of *Weavering,*[2] in which the Court found that the regime on voidable preferences as set out in Section 145 of the Cayman Islands Companies Law (as amended) applies to redemption payments. A voidable preference is a payment made to a creditor within six months of the commencement of a liquidation where it can be proven that the company intended that the creditor be preferred over other creditors.

Clawback actions may also be taken in respect of redemptions which are considered to be unlawful, which would include any payment by the fund from its capital made at a time when the company is insolvent ie. unable to pay its debts when they fall due.[3]

Directors and managers should assess the fund's position as to solvency and then reassess this on a regular basis when deciding whether to allow redemptions, suspend them entirely or consider another process such as imposing investor or fund-level gates, placing certain investments into side-pockets or restructuring the fund in another way. Simply put, if your fund cannot pay all redemption requests on the specified redemption date allocated under the documents, then the fund is considered insolvent as a matter of Cayman Islands law.[4]

---

[2] *Skandinaviska Enskilda Banken AB v Conway and another (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Ltd)* [2019] UKPC 36

[3] Section 37(6) (a) Companies Law

[4] *Culross Global SPC Ltd v Strategic Turnaround Master Partnership Ltd [2010] UK PC 33*

If an investor, having submitted a valid redemption request in accordance with the fund's documents, cannot be paid on the redemption date, they become a redemption creditor, entitled to payment ahead of other investors and with standing to petition to wind up the fund on grounds of insolvency.

Indemnification

A key feature of the Cayman Islands jurisdiction is the availability of contractual indemnities in directors and other service providers such as managers' appointment documentation as well as in the company's articles of association. One by-product of having restrictions on redemption is that investors may band together to try to sue their way out, however the existence of indemnification clauses that require the fund to indemnify the fund manager, typically up to a finding of "gross negligence",[5] "wilful neglect" or "wilful default"[6] may well have the effect of quelling such efforts. Indeed, at the first signs of pressure all relevant stakeholders should check the relevant indemnification language in place: managers and directors to ensure they are adequately protected when making difficult decisions in times of crisis; and investors, who may find it is counter-intuitive to sue when costs and expenses incurred by the manager, including legal expenses to defend against investor court proceedings, must be paid by the fund, thereby further reducing the pool of assets available for distribution. In practice, there is a very high threshold to succeed in establishing that a director's acts disentitle him or her from relying on an indemnity. This fact is often enough to disincentivize investors from pursuing expensive legal action in favour of cooperation with the fund manager to exercise workouts and modifications, and preserve capital. Of course not all claims will be capable of being covered by a director or manager's indemnity, including exemption from liability of core fiduciary duties, such as the duty to act honestly and in good faith, or fraud which cannot be excluded as a matter of public policy.[7]

Conclusion

As we have outlined above, those with the responsibility for the governance of funds tend to have extensive powers to exercise in situations like this. Time is of the essence in times of crisis; the right powers must be exercised at the right time and not too late (you can't suspend redemptions after a redemption date has passed, for example, but may be able to delay or suspend payment of redemption proceeds), but the key point to remember is that directors must have the best interests of the fund, and not their own interests or the interests of others, such as the manager, in mind when making these decisions. In normal liquidity situations, it may be sufficient for the fund to suspend redemptions and manage redemption requests accordingly, after which the suspension may be lifted and the fund continue to operate. Of course, unfortunately, in practice, the fund can't always trade out of distress.

In our next two posts we will discuss options for stakeholders when a formal restructuring is required; when a liquidity event of the type discussed above cannot be resolved and a wind down is required; or when a disgruntled investor takes action for recovery of their investment. But for now, the message for boards, managers, service providers and investors is to keep in touch with one another and your lawyers. With careful management and good advice, a period of suspension does not have to mean the end of the fund.

Matt Taber
+1 345 815 2946
matt.taber@harneys.com
Cayman Islands

Nick Hoffman
+1 345 815 2916
nick.hoffman@harneys.com
Cayman Islands

Grainne King
+1 345 815 2934
grainne.king@harneys.com
Cayman Islands

For more information and key contacts please visit **harneys.com**

[5] as defined in *Primeo Fund v Bank of Bermuda and HSBC Securities, CICA Civil Appeal No 21 of 2017*

[6] as defined in *Peterson and Ekstrom v Weavering Macro Fixed Income Fund Ltd* [2015] 1 CILR 45

[7] See *Renova Resources Private Equity Ltd v Gilbertson* [2009] CILR 268; *Re Bristol Fund Ltd, [2008] CILR 317*

© Harneys, April 2020

Harneys is a leading international offshore law firm. From locations around the globe, Harneys advises the world's top law firms, financial institutions and corporations on the laws of British Virgin Islands, Cayman Islands, Cyprus, Luxembourg, Bermuda, and Anguilla. For more information about Harneys please visit harneys.com or contact us at marketing@harneys.com.

The foregoing is for general information only and not intended to be relied upon for legal advice in any specific or individual situation. Bermuda legal services are provided through an association with Zuill & Co which is an independently owned and controlled Bermudian law firm.