

Cayman Court overrules valuation placed upon redemption paid in kind

The Grand Court of the Cayman Islands has set out the principles to be applied to the valuation of redemptions in kind and to the interpretation of discretions bestowed upon directors in constitutional documents

Executive summary

On 18 April 2012 the Grand Court ordered the winding up of FIA Leveraged Fund (the “**Fund**”) on the basis that the Fund, having failed to transfer assets of sufficient value upon a redemption in kind, was unable to pay its debts. The Grand Court rejected the value placed on the assets by the Fund.

This is the first decision of a Cayman Islands Court on the application of in kind distribution powers and affirms a number of principles applicable to the powers of directors and the interpretation of the constitutional documents of Cayman Islands funds.

Facts

The Fund was formed as a Cayman Islands exempted company and had appointed Fletcher Asset Management, Inc. as its Investment Manager. Three US pension plans (the “**Plans**”) had made investments totalling \$100 million in the Fund which they sought to redeem in 2011. Valid redemption requests were served for a total redemption value of \$144,500,000. The redemption amount was due by way of an initial payment of approximately \$136,000,000 with the balance to follow after the annual audit.

After an initial dispute concerning the process of redemption, the Fund delivered assets (the “**In Kind Assets**”) to the Plans in proposed satisfaction of the redemption requests. The In Kind Assets comprised shares in a special purpose company holding rights to acquire convertible preferred securities and warrants in a listed US bank (the “**Bank Issuer**”) at an acquisition price of \$65,000,000 (the “**Acquisition Price**”). Given the nature of the rights, securities and warrants underlying the In Kind Assets, the In Kind Assets embedded a true derivative with optionality. Those rights, securities and warrants were not publically tradable though they were ultimately convertible to the listed stock of the Bank Issuer. A dispute had arisen with the Bank Issuer as to the economic terms of the arrangements following a reverse stock split by the Bank Issuer.

The constitution of the Fund provided that the valuation of the In Kind Assets should be

determined “by the Board of Directors in consultation with the Investment Manager in its sole discretion”. The board of directors of the Fund valued the In Kind Assets with input from the Investment Manager and a third party professional valuation firm at approximately \$136,000,000 and thus sufficient to settle the initial redemption payment. That valuation was on the basis that the Fund would be successful in the dispute with the Bank Issuer.

The Plans alleged that the In Kind Assets were worth substantially less than \$136,000,000 on a variety of alternative valuation methods and petitioned for liquidation of the Fund on the basis that, by failing to satisfy the initial redemption payment, it was cash flow insolvent. Those alternative valuations included assuming the Fund would be unsuccessful in its dispute with the Bank Issuer and looking to the Bank Issuer’s evaluation of the In Kind Assets in its accounts.

Decision

As a finding of fact, the Court rejected the valuation by the Fund primarily on the basis that in the Court’s view the professional valuation firm had omitted to reflect the Acquisition Price properly in the valuation of the In Kind Assets. The Court found the valuation of the In Kind Assets was at best \$65,000,000 (being the Acquisition Price) lower than \$136,000,000. All other valuation methods resulted in lower valuations.

In relation to the directors’ “sole discretion” when valuing the In Kind Assets, the Court noted:

1. such words are understood to bear the meaning they would convey to a reasonable person against the relevant commercial background, and it would be unreasonable to conclude the words give the directors an unfettered discretion to distribute assets in a manner which could not be expected to give commercial efficacy to the obligations owed, and
2. the directors owe a duty to act in good faith and the constitutional and contractual terms would not impliedly sweep that away.

The Court determined that the valuation did not achieve commercial efficacy and accordingly the Plans remained material unpaid creditors of the Fund. Further, the Court was of the view that the Fund had shown no substantial ground to dispute the Plans' claims and accordingly the liquidation order was made.

The Court also noted that it would have granted the order on wider just and equitable grounds on the basis the Fund's substratum had failed, i.e. it was no longer possible for the purposes of the Fund to be achieved.

We would highlight that the judgment

1. does not explore whether the same valuation basis was used for fixing the US dollar redemption payment amount and the subsequent valuation of the In Kind Assets applied in payment, and
2. makes reference to the need for the Plans to fund the Acquisition Price (thus suggesting the valuation can be a function of a party's own funding position).

The decision is subject to a pending appeal.

Key Practice Points

Clients should consider the following:

1. *Exercise of sole discretions* – constitutional documents ordinarily reserve a number of discretions to the directors on a "sole" or "exclusive" basis (for example, valuation, expulsion and transfer approval provisions). The decision makes clear that such provisions cannot override the wider duties of the directors to their company and the overall commercial context of the arrangements. The Court is clearly willing to reassess the exercise of a discretion that is not in line with those duties. Promoters should
 - a. apply a robust process when exercising any sensitive discretion, and
 - b. consider amending constitutional and related provisions to reduce the risk of challenge (for example, see point 2 below).

2. *Enhanced valuation procedures* – the decision underscores the need for transparent processes around any valuation (whether periodic or exceptional). The issue is particularly acute where no market exists for the relevant asset and model based valuations are required; for example, illiquid assets and those that embed a derivative.

Model based valuations are clearly susceptible to challenge and revaluation using alternative methodologies. We recommend client funds review their constitutional and procedures documents and as necessary add language in areas of potential dispute, for example, by

- a. stating the types of models that will be used (such as Black Scholes Merton for structures with optionality),
 - b. stating the main assumptions and pricing/input sources,
 - c. referring to relevant industry standards,
 - d. disregarding the funding, collateral or wider portfolio position of the parties or intermediate holding vehicles,
 - e. requiring appropriate consistency, such as providing that the valuation process for in kind payments must mirror the process for valuation of the related redemption amount, and
 - f. adding specific risk factors.
3. *Avoiding a winding up petition* – the case highlights, in line with a number of recent decisions, that the Court is willing to wind up a fund where it appears no longer possible to achieve its purposes. Promoters may wish to consider adding provisions that limit the ability of investors to bring winding-up proceedings.

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This Client Update is intended to provide only general information for the clients and professional contacts of Travers Thorp Alberga. It does not purport to be comprehensive or to render legal advice. Please do not hesitate to contact us if you would like more detail on any of the points made in this Client Update.

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