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ARTICLE

Cayman Islands Court of Appeal Clarify Law in Favour of Redeeming Investors

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On 20 November 2015 the Cayman Islands gave its long awaited decision in *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund (in Official Liquidation)*. The decision held that redemption payments made to RMF Neutral Strategies (Master) Limited ('RMF') by DD Growth Premium 2X Fund (the '2X Fund'), at a time when it was subsequently shown that the 2X Fund was insolvent, were not capable of being clawed back by the liquidators of the 2X Fund. The decision creates certainty for investors and is a disappointment to many liquidators who may have wished to pursue clawback claims of their own.

In the fallout to the 2008 financial crisis it became apparent that many Cayman Islands' hedge funds had made redemption payments to investors at a time when they were, as a matter of fact, insolvent. There were potential claw backs of such payments from investors by liquidators of funds that had made such payments because of the provisions of section 37(6)(a) of the Companies Law (2007 Revision) (the 'Law') which provided as follows:

> 'A payment out of capital by a company for the redemption or purchase of its own shares is not lawful unless immediately following the date on which the payment out of capital is proposed to be made the company shall be able to pay its debts as they fall due in the ordinary course of business.'

The critical question of concern to the legal profession, insolvency practitioners and investors alike was what amounted to a payment out of capital for the purposes of section 37(6)(a).

Taking pre-emptive action to avoid the need to await the expiry of the limitation period, RMF brought an action in the Grand Court of the Cayman Islands seeking a negative declaration that the sums paid by 2X Fund for the redemption of redeemable shares held in the 2X Fund had been lawfully paid and received; arguing that any payments made were payments out of share premium, not payments out of capital and therefore did not fall foul of section 37(6)(a). The liquidators sought to recover sums paid to RMF on the basis that they had been paid unlawfully contrary to section 37(6)(a) of the Law, and that the payment made to RMF was a voidable preference payment.

The matter first came before the Grand Court in September 2014 with the Chief Justice delivering his judgment on 17 November 2014. The Chief Justice found in favour of RMF on both the construction of section 37(6)(a) and the voidable preference claim.[2]

The Chief Justice was unequivocal in adopting the interpretation of the Law proffered by RMF, holding that save for a *de minimis* amount of USD1/1000 per share, the purchase price of the 2X Fund's shares represented share premium.

The Chief Justice came to his decision because of section 34(2) of the Law which provides for the uses to be made of money in a company's share premium account, providing as follows:

> 'The share premium account may be applied by the company subject to the provisions, if any, of its memorandum or articles of association in such manner as the company may, from time to time, determine including, but without limitation –
>
> a) Paying distributions or dividends to members;
>
> b) ...
>
> c) In the manner provided in section 37;
>
> d) ...
>
> e) Writing off the expenses of, or the commissions paid or discount allowed on, any issue of shares or debentures of the company; and
>
> f) *Providing for the premium payable on redemption of any shares or debentures of the company*:
>
> Provided that no distribution or dividend may be paid to members out of the share premium account unless, immediately following the date on which the distribution is proposed to be paid, the company shall

Notes

1 Paul Smith and Ben Hobden of Conyers Dill & Pearman acted on behalf of RMF, the successful Respondent.

2 The voidable preference claim did not form part of the liquidators' appeal and is not considered further herein.

be able to pay its debts as they fall due in the ordinary course of business; and the company and any director or manager thereof who knowingly and wilfully authorises and permits any distribution or dividend to be paid in contravention of the foregoing provision is guilty of an offence and liable on summary conviction to a fine of fifteen thousand dollars and to imprisonment for five years.'

With reference to section 34(2) the Chief Justice determined that share premium was not to be regarded as being part of the share capital of a company or subject to the regime in section 37.

The liquidators had sought to argue that their position was strengthened by reference to section 37(5)(a) which provided that:

'Subject to this section, a company limited by shares or limited by guarantee and having a share capital may, if so authorised by its articles of association, make a payment in respect of the redemption or purchase of shares otherwise than out of profits or the proceeds of a fresh issue of shares.'

The 2011 amendment to the Law added 'share premium' to the list in section 37(5)(a) and the liquidators contended that its absence in the 2007 Law meant that share premium was by section 37(5)(a) deemed to be capital for the purposes of section 37(6)(a). This argument was dismissed by the Chief Justice as being a 'strained and tortuous construction'.

In effect, the Chief Justice found that there were two separate regimes in place: that provided for in section 34 for share premium, and that provided for in section 37 for share capital. This conclusion was reinforced by the reference to the 'manner provided in section 37' found in section 34(2)(c) and that section 34(2)(f) provided that the share premium account could be used to redeem shares, without any solvency test being imposed.

Thus, it was held, a company could use its share premium for the purposes of redeeming shares, even if the company was cash flow insolvent. The Chief Justice believed that this reflected the expectations of investors in an open ended hedge fund where investors were regularly issued with shares at a price in excess of their par value and that pursuant to a company's constitutional documents (at least in this instance) they were to be redeemed on the basis of NAV per share out of share premium in the ordinary course of business.

The liquidators appealed the judgment of the Chief Justice to the Court of Appeal, claiming, *inter alia*, that the Chief Justice wrongly construed the Law, and used impermissible methods of construction to come to his judgment.

In a relatively brief judgment dated 20 November 2015, the Court of Appeal (with Sir Richard Field, JA, giving the leading judgment) wrestled with issues of construction, which it described as 'a difficult question'.

In coming to its decision in construing the Law, the Court of Appeal stressed that whilst it did have in mind many of the factors that the Chief Justice had taken into account when construing the Law, it specifically made no finding as to what the expectations of investors would be.

The Court of Appeal concurred with the construction given to the Law by the Chief Justice at first instance. The Court of Appeal were not persuaded that the meaning and effect of section 37(5)(a) and (b) is that a payment out of share premium for the redemption or purchase of its own shares is a payment out of capital for the purposes of section 37(6)(a).

The Court of Appeal was very clear in its judgment: section 37 must be read as a whole and also in the light of section 34. The Court of Appeal held that standing alone, section 34 proceeds on the basis that payments by a company out of share premium for the purchase of its own shares are not payment of capital and as such are not subject to any solvency test. The Court of Appeal held that this must be so given the content of section 34(2)(f) and that 'it was not the legislative intention that payments by a company out of share premium in respect of the redemption or purchase of its own shares were to be swept into the extended definition of capital contained in s. 37(5)(b) and thereby made subject to the solvency requirement in s. 37(6)(a).'

The Court of Appeal went on to hold that it would only be if section 37 very clearly provided that payment out of share capital for the purchase or redemption of shares was to be treated as a payment of capital that the strong indication of section 34 would be neutralised.

The decision of the Court of Appeal is a victory for common sense, even if liquidators stand to be disappointed. The Cayman Islands prides itself as being an investor friendly jurisdiction. It appears axiomatic that an investor in an open ended fund (many of whom are funds of funds) would wish to be safe in the knowledge that monies received by way of redemption payments are not potentially subject to any claw back claims. The legislature made this perfectly clear in the amendment to the Companies Law made in 2011. The current law makes it clear that paying redemption payments out of share premium is permissible. In delivering its judgment, the Court of Appeal obviously shares the view of Conyers; the 2011 amendments were nothing other than a 'tidying up' of the settled law in this area.

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