

# Practical approach

When hedge funds become illiquid, what options are open to investors?

## 1 MINUTE READ

The 2008 financial crisis led to a surge in the number of funds facing liquidity issues. This was, in part, down to global macro events, but more prominently as a result of unrealistic expectations of liquidity as against investment return.

This article is a discussion and analysis of the options open to investors by Cayman law when issues of liquidity arise. Firstly, looking at the wind down process associated with normal liquidity situations, partner Matthew Taber and senior associate Katie Pearson assess the process associated with suspension of redemptions, followed by an analysis of an official court room liquidation.

**H**edge funds are typically high risk, high reward investments. However, when high risk investment strategies fail to pay off, the true liquidity of underlying assets may be revealed to not be quite as the promotor, or perhaps more importantly, the investors hoped. The 2008 financial crisis led to a surge in the number of funds facing liquidity issues. Some of these issues were down to global macro events, but many were due to unrealistic expectations of liquidity as against investment return. Since then, funds and those advising them have become much more alert to addressing liquidity issues, but these problems are by no means a thing of the past.

It's worth considering what options may be available to investors in Cayman funds whose underlying assets have become illiquid and the likely outcomes, including in relation to the termination of the fund. The focus here is on funds that are established as corporate vehicles, since this is the typical structure used by promoters of Cayman Islands hedge funds, but many of the points made also apply to other structures, albeit with slight differences.

## Powers and duties of the management of the fund

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. These fiduciary duties curtail the fund's ability to offer a settlement or even different redemption terms to one investor that is not open to other investors. Under Cayman Islands law, the investment manager is simply a service provider to the fund and does not owe separate Cayman Islands legal duties to the investors in the fund. This is different, for example, to the situation that exists in the US under US and state securities laws where the investment manager may also owe fiduciary duties to investors.

The broad scope of the directors' powers will be set out in the articles of association (AoA) and often accompanied by disclosure in the relevant offering document as to how those powers might be exercised in practice. The AoA usually allow management to take steps for the protection of investors as a whole if the fund is facing liquidity issues. Depending on the vintage of the fund, these will usually include the power to suspend investor redemptions and the payment of redemption proceeds, and perhaps even the power to establish side pockets to separate illiquid from liquid assets. Side pockets largely lost favour in the years immediately following the financial crisis, but they have started to make a comeback in some circumstances. 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. In those circumstances, assets may be transferred to a new vehicle established for that purpose, and redeeming investors would receive securities issued by that entity rather than being paid in cash.

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.

### Soft wind-down by the fund's management

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 in operation. However, that may not always be possible and a liquidity event may be a tipping point to the termination of the fund.

In those circumstances, the directors, working with the investment manager, will generally wish to manage the wind-down process themselves using the powers outlined above. There are often good reasons for this. For example, due to their familiarity with the investment portfolio of the fund, the pre-existing management are often better placed than court-appointed liquidators to oversee their run-off in a cost-efficient manner. Sensible steps for investment managers to take include offering to reduce their fees for the run off period (while at the same time balancing the need to be able to keep trading), and offering investors increased transparency

over the liquidity and makeup of the portfolio.

In the immediate wake of the financial crisis there were a number of court cases in the Cayman Islands which looked at aspects of illiquid funds and how they should be addressed. In particular, the Grand Court held in 2010 that funds might be wound up on the just and equitable ground *'if the circumstances are such that it has become impractical, if not actually impossible, to carry on its investment business in accordance with the reasonable expectations of its participating shareholders, based upon representations contained in its offering*

the company up or petition on the just and equitable ground, whereas creditors will more usually be the ones to issue a winding-up petition against the company on the ground of inability to pay debts. If authorised to do so by the AoA, directors may also present a winding-up petition. Relevant circumstances giving rise to an ability to petition on the just and equitable ground include loss of substratum (as discussed above), loss of confidence in management due to a lack of probity on their part, and the need for an investigation into the affairs of the fund.

Without exception, the mere fact of a

## While a winding up petition is pending, a prudent company will seek a Court order validating any transactions involving a disposition of property

*document.*' On that basis, funds which were in soft wind-down but which had not previously disclosed the fact that a severe liquidity problem or extended suspension of redemptions might trigger a soft wind-down, were held to have lost their *substratum* which justified a winding up on the just and equitable ground. However, more recently, in 2015 and 2016, the Grand Court has declined to follow that line of case law, and has declined to wind up funds which were already in soft wind down. Additionally, most fund documents now contain clear disclosure that the business of the fund includes a soft wind-down by the management of the fund in the event that there is a prolonged suspension of redemptions or severe liquidity situation which would make it difficult, if not impossible, for an investor to seek a winding-up on this ground.

### Official liquidation – court process

In certain circumstances, for example where the fund is insolvent or where there have been allegations of fraud which require independent investigation, the only sensible thing to do will be to have the fund put into the official liquidation process.

There are two main grounds for doing this: inability of the company to pay its debts as they fall due (ie insolvency), or the just and equitable ground. A shareholder will typically be the person to make the application to wind

creditor or shareholder bringing a winding up petition has drastic consequences for the fund's business, irrespective of whether the petition is eventually successful, not least because petitions are generally advertised (in the case of a creditor's petition, automatically and in the case of a shareholder's petition, if the Court orders it), and because the Companies Law provides that if a winding up order is made, any disposition of the company's property or alteration in the status of the company's members subsequent to the winding-up petition being brought is void unless the Court orders otherwise. This means that while a winding up petition is pending, a prudent company will seek a Court order validating any transactions involving a disposition of property.

An alteration in the status of the company's members includes a transfer or cancellation of shares held by the members. This means that, while there is an active secondary market for shares in distressed funds, any sale or transfer of shares in a fund which is either in liquidation or has a winding up petition pending will require court authorisation, as will any cancellation of the shares. While this is generally a straightforward application, it is another reason why a soft wind down might be preferable in certain circumstances.

Given the drastic consequences, a winding-up petition is often referred to as the so-called nuclear option and is supposed to be a remedy of last resort.

If a winding up petition is successful, official liquidators will be appointed by the Court. The job of the official liquidators, who will be licensed insolvency practitioners, is to collect in the fund's assets, pay creditors and, if there is a surplus, distribute any remaining amounts to shareholders. As with management, liquidators owe duties to act in the best interests of the company (which in an insolvent liquidation, means the best interests of the creditors until the creditors have been satisfied in full), but unlike management they have additional powers and protections as court-appointed officers. These include additional powers of investigation and powers to claw back assets of the company in certain circumstances.

It is commonly perceived that an official liquidation will lead to a fire sale of assets and corresponding loss of value for investors, but this does not need to be the case. Liquidators don't need to sell assets if they consider that retaining ownership and managing assets is in the best interests of the company. They can also seek Court sanction for steps they propose to take, giving them added protection.

The 2017 decision of the Privy Council in *Pearson v Primeo Fund* confirmed that investors who have redeemed their investment prior to the date of commencement of 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 redemptions), the early submission of a redemption request is critical in order to ensure priority in any distribution of assets.

### Looking forward

To a large degree, some of the worst situations that were faced by funds in the financial crisis have been addressed by better and clearer fund documentation. Managers and advisers to funds are now very much alive to the issues that can arise from a liquidity mismatch (when the redemption frequency is not in line with the investment strategy or investments held). Management of funds have extensive powers to exercise in situations like this, but the key point to remember, is that they must have the best interests of the fund, and not their own best interests, in mind when making decisions regarding the future of the fund.

## If a liquidation is on the cards, the early submission of a redemption request is critical in order to ensure priority in any distribution of assets

Unfortunately, when funds experience difficulties with liquidity, our experience is that they often do not survive. However, well-structured funds that engage with their investors early will be able to manage the wind down process in a way that preserves as much investor value as possible. Additionally, particularly in the Cayman Islands, liquidation professionals now have significant experience in dealing with large numbers of liquidity situations.

Given the complex issues involved, investors in funds must get legal advice an early stage if funds in which they are invested in are facing liquidity difficulties.



**Matthew Taber**  
Partner  
Harneys, Cayman Islands



**Katie Pearson**  
Senior associate  
Harneys, Cayman Islands