

UPDATE

Ardon Maroon Asia Master Fund – the narrow test for appealing a rejection of a proof of debt in the Cayman Islands

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In a judgment delivered on 17 July 2018¹, the Grand Court of the Cayman Islands refused an application to set aside a decision by joint official liquidators to reject a proof of debt.

The potential creditor, a feeder fund, argued that its proof of debt for redemption proceeds was valid despite the absence of a redemption request in circumstances where, it was alleged, the master fund had disregarded or waived the constitutional requirement for a separate redemption request to be made.

The decision provides clear guidance as to the court's strict application of the legal principles of construction when considering a rejection of a proof of debt. The court firmly dismissed all of the potential creditor's attempts to rely on evidence of subjective intent and market practice in order to circumvent the failure to submit a redemption request. Insolvency practitioners will welcome the certainty delivered by this decision to the assessment of proofs of debt and the need for potential creditors to provide specific probative evidence to prove a purported variation of the written constitutional procedure.

Background

Ardon Maroon Asia Dragon Feeder Fund (**Dragon**) was a feeder fund for Ardon Maroon Asia Master Fund (the **Master Fund**) (together, the **Funds**), which shared the same individuals as directors.

Dragon received and accepted a redemption notice from one of its shareholders in 2014. Given that Dragon's sole asset was its shareholding in the Master Fund, it looked to the Master Fund to meet the redemption. However, the Master Fund's assets were illiquid and could not be readily realised to raise the required US\$15 million.

The directors of the Funds resolved to suspend redemptions and the payment of redemption proceeds, which were subsequently recorded as a debt in the books of Dragon and its NAV was adjusted accordingly. The Funds were wound up voluntarily by shareholder resolution.

Dragon's joint official liquidators (the **Dragon JOLs**) eventually admitted the shareholder's proof of debt. However, the joint official liquidators of the Master Fund (the **Master Fund JOLs**) rejected Dragon's proof of debt. The Dragon JOLs appealed this rejection to the court.

¹ *Re Ardon Maroon Asia Master Fund (In Official Liquidation)*, unreported 17 July 2018

The test for appealing a rejection of a proof of debt

The court as a preliminary matter clarified its function when conducting a *de novo* adjudication of a rejection of a proof of debt. The appeal is treated as a re-hearing at which additional evidence is permitted and is not restricted to the evidence which was submitted to the liquidator with the proof of debt. The potential creditor must provide *satisfactory proof* on the balance of probabilities that the claim is founded on a real debt. The burden is therefore on the potential creditor, by relying on specific probative evidence, to satisfy the liquidator or the court on appeal as to their debt.

The court stressed that the scope of the appeal is narrow and, in anticipation of the Dragon JOLs' arguments, clarified that it is not the court's concern to *pass general judgment on the methodology and practices of the investment industry*.

No authority to disregard or waive the redemption procedure

The Master Fund's articles, as expected, required that a request for redemption be made by notice in writing, although the directors were expressly permitted to vary the period of notice. The Master Fund JOLs accordingly asserted that the directors of the Master Fund, irrespective of any question over what they may have intended, had no power under the articles to disregard the requirement for a redemption notice to be submitted by Dragon.

The court agreed, rejecting the Dragon JOLs' argument that the alleged power to disregard the redemption procedure existed as part of the directors' general power to determine the rights attached to the shares. It made no sense to confer upon directors a further power to entirely disregard the clear redemption procedure which was already expressly set out.

The court also rejected the alternative argument that the directors had waived the redemption procedure - its prior finding on the correct construction of the articles was fatal to both arguments. The waiver point further failed on the evidence, which was not sufficient to establish that the directors unequivocally and intentionally permitted Dragon to proceed on the basis that an effective (notional) redemption notice had been made to the Master Fund notwithstanding the failure by Dragon to serve a further redemption notice on the Master Fund.

No actual determination to disregard the redemption procedure

If the finding on the authority point was wrong (and the directors did have authority to disregard the redemption procedure) the next consideration was whether the directors actually made a determination to that effect. The Dragon JOLs relied upon the terms of Dragon's Private Placement Memorandum provided to investors, which stated that *the redemption procedure for the Master Fund is identical to [Dragon's] procedure*. It was said that this indicated a clear intention by the directors to adopt an automatic back-to-back redemption procedure which only required a single redemption notice (submitted to Dragon) in order to establish an automatic redemption at the Master Fund level. The argument was buttressed by factual and expert evidence to the effect that the automatic procedure was market practice in the fund industry.

The court dismissed this *fragile* argument and resolved as a matter of construction that the natural and ordinary meaning of the statement that the redemption procedure was identical still contemplated two separate identical procedures, not one procedure serving automatically for two purposes. The court was also unimpressed with the Dragon JOLs' reliance on evidence of market practice, considering it to be of no actual probative value and unhelpful. While it was possible to have automatic back-to-back redemption occurring in practice, the question for the court was narrower, namely whether this process was constitutionally authorised and, if so, whether a determination to that effect had actually been made. Aside from this, there was also direct objective evidence in the form of a written resolution of the directors stating that the procedure required *receipt of notice from any Feeder Fund requesting redemption*, which the court favoured over the Dragon JOLs' theoretical construction.

Comment

The implications of this decision are that potential creditors will be expected to adduce specific probative evidence to meet their burden of satisfying the court that a real debt exists. This will be vital where arguments

are pursued which potentially conflict with the natural and ordinary meaning of the articles and the constitutionally enshrined powers. A statement of intention per se is not the same as a determination and is unlikely to be given substantial weight, if any, in the judicial exercise of construing contractual terms. Directors wishing to vary procedures, within their constitutional authority, should make formal resolutions rather than rely on informal arrangements or representations.

It is unlikely that the court will be receptive to standalone evidence of market practice. The appropriate question is what is constitutionally permissible. It is not for the court to define lawful operational procedure.

The court was also concerned by the attempt to rely upon the existence of common directors across the Funds to support the argument that the redemption procedure between them was automatic, considering this to consciously infringe the doctrine of corporate responsibility and the legal separation between corporate entities. This is a principle which the courts have persistently recognised in the Cayman Islands and which underpins the operation of the hedge fund industry. It can't be assumed, in the absence of clear evidence or agreement, that one corporate entity will copy the practice of another merely because they have common directors.

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