DECEMBER 2015

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UPDATE

Grand Court Orders the repayment of redemption monies: Preferences and clawing back redemption payments

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In *Conway and Walker (as joint official liquidators of Weavering Macro Fixed Income Fund) v SEB* the Grand Court of the Cayman Islands has, for the first time, ordered the re-payment of redemption proceeds paid by a fund to an investor shortly before the commencement of the fund's liquidation on the basis that the payments constituted voidable preferences.

Facts

Weavering Macro Fixed Income Fund (the **Fund**) was placed into liquidation in March 2009 after it was revealed that the Fund's main asset, being a basket of interest rate swaps entered into with a related entity, were worthless (the **Swaps**). The Swaps were the tool used by the Fund's principal investment manager, Mr Magnus Peterson, to perpetrate a massive fraud, for which he is now serving 13 years in prison.

The Swaps which, by the end of the Fund's life were valued at over US$600 million, had the effect of masking huge trading losses which the Fund was actually suffering through its true trading activities (principally options and futures). Whereas the true position was that the Fund was never profitable, through the use of the Swaps, and attributing fictitious values to them, the Fund was able to report a steady growth in its net asset value (**NAV**).

In October 2008 the Fund received a large number of redemption requests from investors (the **December Redeemers**). The Fund offered monthly redemption days, being the first business day of each month, subject to a 30 day notice period. Redemption requests received during October 2008 were thus payable in accordance with the 1 December 2008 redemption day. Based on the reported NAV these redemption requests totalled approximately US$138.4 million. Although at this time the Fund's reported NAV was approximately US$583 million, the value attributed to the Swaps was approximately US$626 million. Given that the Swaps were worthless, upon the US$138.4 million of redemption obligations becoming a liability of the Fund, the Fund was rendered hopelessly insolvent – on both balance sheet and cash flow bases.

Notwithstanding, on 19 December 2008 the Fund paid out over US$7.5 million to six of the December Redeemers. These payments represented the totality redemption sums due to these investors (or, in the case of the defendant, the totality of the redemption sums due with respect to one of its accounts: see below) and were paid out on the express instruction of Mr Magnus Peterson on the basis that these investors were, at least in his eyes, to re-invest in a related fund within the Weavering family.

Having insufficient cash from which the balance of the redemption proceeds could be paid, on or about 31 December 2008 the Fund purportedly implemented a policy by which the December Redeemers would receive an initial payment of 25 per cent of their redemption proceeds, with the balance paid over time. This saw most, but not all, investors (save for those who had already received their redemption proceeds, in full, on 19 December 2008) receive 25 per cent of the sums due to them on 2 January 2009, with additional sums being paid during the months of January and February 2009. By the end of February 2009 all but three of the December Redeemers had received their redemption proceeds, in full. The outstanding sums

due to these three investors totalled about US$48.2 million. No further redemption sums were paid to investors prior to the commencement of the Fund's liquidation on 19 March 2009.

This policy however ignored the additional redemption obligations which the Fund incurred on the 2 January and 2 February 2009 redemption days, arising out of redemption requests made by investors during the months of November and December 2008 (the **January** and **February Redeemers**). These redemption sums totalled approximately US$54.7 million and US$30.0 million respectively, and represented additional liabilities of the Fund as and from each redemption day. Despite the Fund paying out approximately US$72.3 million during January 2009 and US$10.2 million during February 2009 to the December Redeemers, no redemption payments were made to either the January or February Redeemers.

The effect of these redemption payments was that:

- the six December Redeemers paid, in full, on 19 December 2008 were preferred to the balance of the December Redeemers;
- the December Redeemers who received their redemption payments, in full, were preferred to the three December Redeemers who received only part payment of their redemption proceeds prior to the commencement of the Fund's liquidation; and
- all of the December Redeemers were preferred to the January and February Redeemers who received nothing.

SEB

The defendant, SEB, was the registered holder of shares in the Fund. Although it held a number of accounts, two were relevant for the purposes of the proceedings. Via these accounts SEB held two separate shareholdings, and in each case as nominee for an underlying investor. It submitted redemption requests for each of these shareholdings in October 2008, and was thus a December Redeemer for both albeit, with respect to one of these accounts, it was one of the investors who Mr Magnus Peterson believed would be re-investing in another Weavering fund, and received its redemption proceeds on 19 December 2008. Redemption proceeds with respect to its other account were paid on 2 January 2009 and 11 February 2009. In all, SEB received over US$8.2 million in redemption proceeds during this period.

The Liquidators' case was that the payments made to SEB were recoverable in accordance with section 145(1) of the Companies Law. That section relevantly provides that:

1. Every…payment…made in favour of any creditor at a time when the company is unable to pay its debts within the meaning of section 93 with a view to giving such creditor a preference over other creditors shall be invalid if made… within six months immediately preceding the commencement of a liquidation.

Decision

In finding that each of the payments made to SEB constituted a voidable preference, and were to be repaid, the court was required to determine a number of issues.

Controlling Mind

Despite not forming part of the Fund's board of directors, the Liquidators' principal case was premised on the notion that Mr Magnus Peterson was the Fund's controlling mind. This was accepted by the court, based on an analysis of the evidence before it – including evidence of the payment instructions given by Mr Magnus Peterson to pay the redemption proceeds themselves, as well as an analysis as to how the Fund operated generally, and the very limited role played by its directors.

Solvency

Following the decision of *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited*[1] the court found that the December Redeemers became creditors of the Fund on 1 December 2008, with the redemption sums due representing debts of the Fund. In reaching this conclusion the court dismissed SEB's argument that the Fund's offering memoranda, which provided that redemption payments were 'generally

[1] [2010] UKPC 33.

made within 30 calendar days after the Redemption Day' meant that, while the December Redeemers became creditors on 1 December 2008, they did not become 'current creditors' until expiration of this 30 day period, with the consequence being that the redemption obligations were not to be considered debts, at least for the purposes of section145 of the Companies Law, until that time. In rejecting this argument the court adopted the view that this 30 day 'grace period was a purely practical measure to allow for the orderly payment of sums which had become due on the redemption date'. It in no way affected the obligation itself.

SEB further argued that, given the NAV upon which the relevant redemption obligations were premised was fraudulent, the NAV was not binding and the December Redeemers did not become creditors – with the consequence that there was nothing due to them, thus the Fund had no creditors[2] (and, as a corollary, no creditors over which SEB could have been 'preferred'). In rejecting this argument the court found that the NAV was binding, as provided for by the Fund's articles of association, which was entirely consistent with the Privy Council's decision in *Fairfield Sentry*[3]. As regards Mr Magnus Peterson's fraud, the court had no difficulty in observing that it is possible for a company to rely on attribution of a person's knowledge for one purpose whilst disclaiming attribution of that same person's knowledge for another.[4] Thus Mr Magnus Peterson's knowledge of the true position as regards the Swaps and the insolvency of the Fund were to be attributed to the Fund itself, but his fraud was not.

Payments made with a view to preferring SEB over other creditors

The court reaffirmed the position that it was not enough for the Liquidators to show that the payments made to SEB had the effect of preferring SEB over other creditors. In doing so the court drew heavily on the Chief Justice's comments in *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund*[5] (a case in which liquidators similarly sought the recovery of redemption proceeds, albeit were unsuccessful in their attempts to do so[6]), in particular in confirming the need to demonstrate a 'dominant intention to prefer' in order to enliven section 145. In doing so, the court also reaffirmed the position that the requisite intention can be inferred from the circumstances; there need not be direct evidence.

After undertaking a detailed analysis of the development of the law, the court adopted the view that in demonstrating the dominant intention to prefer, it is possible to do so by showing a dominant intention to prefer a particular 'class' of creditor. The court then undertook a detailed analysis of the evidence (including Mr Magnus Peterson's instructions that SEB, and the five other investors referred to above, be paid out ahead of all other December Redeemers) and, placed in its proper context, concluded that the requisite dominant intention was present with respect to the payments made to SEB.

Defences

The court unequivocally rejected the notion that common law defences – including change in position - are available in order to defeat a statutory preference claim. This is so even if, as was the case here, the recipient was acting as a nominee.

In support of its argument SEB sought to rely on the wording of section145 itself, in that it does not provide a particular cause of action or other mode of recovery once a payment is declared invalid.[7] SEB went on to argue that, in the circumstances, any recovery would need to be made by seeking restitution based on principles of unjust enrichment – thus seeking to open the door to, and avail itself of, common law defences which may then be available. In dismissing this argument the court was of the view that the cause of action derives from the section itself, holding that 'pursuant to the statute the payment is invalid, therefore, the recipient is obliged to repay what he received'.

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[2] And similarly, investors who sought to redeem their shares in January and February 2009 did not become creditors.

[3] [2014] UKPC 611.

[4] Applying *Jetiva SA v Bilta (UK) Limited* [2015] UKSC 23.

[5] [2013] 2 CILR 361

[6] Principally on the basis that the relevant payments were found to have been made as a result of unrelenting and escalating pressure as opposed to any dominant intention to prefer.

[7] And in this regard the provision is to be distinguished from the equivalent provision in England.

Notably, even if a change of position defence was available, the court expressed the view that such a defence was not made out. Although there was no question that SEB, as nominee, had paid away the redemption proceeds, it had done so in accordance with its own separate obligations it had entered into with the underlying investors. In the court's words, this did not involve any change of position; it was rather the consequence of the position of being a nominee. SEB could not shelter behind being a nominee; it must accept the consequences of being the registered legal owner of the shares.

Illegality and public policy

It is settled principle that a court will not lend its aid to a litigant whose cause of action is founded on an illegal act. In reliance on this principle SEB sought to argue that the Liquidators were seeking to rely on a published NAV which was fraudulent, and published in furtherance of the fraud perpetrated by Mr Magnus Peterson – whose knowledge the Liquidators were relying on in support of their claim. As with was the case on the question of solvency, the court had little difficulty in rejecting this argument, again noting it was possible for the Liquidators to rely on attribution of Mr Magnus Peterson's knowledge for one purpose whilst disclaiming attribution of his knowledge for another. In this context the fraud was the fraudulent valuation of the Swaps by Mr Magnus Peterson, not the actual calculation of the Fund's NAV which was undertaken by its administrator. Approached on this basis, the Liquidators were not seeking to rely on Mr Magnus Peterson's fraud at all.

Discussion

Save for the court's determination that the requisite dominant intention to prefer can be made out by demonstrating a dominant intention to prefer a class of creditor, as opposed to an individual, the court's decision largely applies well known, and established, principles relating to preference claims. The decision is, however, very significant in terms of the way in which it:

- confirmed that the cause of action is founded in the statute itself; recovery of a payment declared to be invalid is not reliant on principles of restitution and a claim for unjust enrichment;
- dismissed the availability of common law defences to a statutory preference claim and confirmed that, when made out, the court has no discretion as to the order to be made – unlike the position in England where the equivalent section grants the court a wide discretion.[8] In the Cayman Islands the payment is invalid and must be repaid; and
- an investor who participates in a fund in a mere nominee or custodian capacity is to be treated no differently to an investor who holds the beneficial interest in its investment; as the registered shareholder, a nominee or custodian is liable to re-pay monies which are shown to constitute a preference. Whether or not the nominee investor is, in turn, able to look to its principal for reimbursement or indemnification is a matter for it, and is unrelated to the question of preference.

In doing so, the court's decision is entirely consistent with the underlying principles governing most common law insolvency regimes: all creditors of an insolvent company ought to be treated equally.

Mourant Ozannes partner Shaun Folpp acted for the successful Liquidators, assisted by Eleanor Morgan, Tina Asgarian and others across Mourant Ozannes' global litigation team. At trial he was led by Mr David Lord QC.

[8] See section 239 of the Insolvency Act 1986.

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