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UPDATE

Clawback of redemption proceeds: Cayman Islands Court of Appeal upholds weavering preference claim (and clarifies a number of significant principles of insolvency law in the process)

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The Cayman Islands Court of Appeal (CICA) has upheld the Grand Court's decision in *Conway and Walker (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Limited) v Skandinaviska Enskilda Banken AB* (PUBL) (SEB) in which it held that redemption payments made shortly prior to the collapse of Weavering Macro Fixed Income Fund (Weavering or Fund) constituted preferences over the Fund's other creditors and must be repaid.

The Cayman Islands Court of Appeal (**CICA**) has upheld the Grand Court's decision in *Conway and Walker (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Limited) v Skandinaviska Enskilda Banken AB* (PUBL) (**SEB**)[1] in which it held that redemption payments made shortly prior to the collapse of Weavering Macro Fixed Income Fund (**Weavering** or **Fund**) constituted preferences over the Fund's other creditors and must be repaid. In doing so, the CICA has clarified and widened the scope of a number of principles which will have a wide ranging affect across a number of aspects of Cayman Islands insolvency law, and not simply limited to preference claims - including the most fundamental principles: the definition of, and demonstrating, insolvency.

The facts

Weavering was placed into liquidation in March 2009 following the discovery of the fraudulent activities of the Fund's principal investment manager, Mr Magnus Peterson. At the heart of his fraud, Mr Peterson used fictitious interest rate swaps to give the impression that the Fund was returning steady profits, when in reality the swaps had the effect of masking huge trading losses. This was done by attributing significant value to the swaps notwithstanding the fact that they were worthless.

Following the collapse of Lehman Brothers in September 2008, a significant number of Weavering's investors sought to redeem their shares. As a consequence, redemptions totalling US$138.4m, US$54.7m and US$30m became due on each of the 1 December 2009, 2 January 2009 and 2 February 2009 redemption days, respectively.

As a result of Mr Peterson's fraud, Weavering was never in a positon to meet these redemption obligations, and was rendered hopelessly insolvent. However, rather than suspending redemptions, or otherwise taking steps to cease the Fund's business, Mr Peterson implemented a policy for the payment of redemptions – albeit only to those investors who redeemed their shares on 1 December 2009 (**December Redeemers**).

In short:

Six of the December Redeemers were to re-invest their redemption proceeds with a related fund, and their redemption proceeds (totalling US$7.6m) were paid out, in full, on 19 December 2008.

[1] Unreported, 4 December 2015, Grand Court of the Cayman Islands, Financial Services Division, Cause No FSD 98/2014, Clifford J.

- In relation to the remaining December Redeemers (of which there were 43) (i) an interim payment of 25 per cent of the redemption sums due was made to each investor in early January 2009; and (ii) thereafter, investors were selected on an ad hoc basis to be paid the balance of their redemption proceeds, albeit with those investors who were owed 'smaller' sums being paid ahead of those investors who were owed 'larger' sums.
- By the time Weavering was placed into liquidation in March 2009 all but three of the December Redeemers had received their redemption proceeds, in full.
- No redemption proceeds were paid to those investors who redeemed their shares on 2 January (**January Redeemers**) and 2 February (**February Redeemers**) 2009, despite the January and February Redeemers becoming creditors of the Fund as and from their respective redemption day.

In all, redemption proceeds totalling US$90.2m were paid out by the Fund during December 2008, January and February 2009 to the December Redeemers. As at the commencement of its liquidation, the Fund still owed in excess of US$132.9m of redemption obligations: US$48.2m to the three December Redeemers who remained unpaid, US$54.7m to the January Redeemers, and US$30m to the February Redeemers.

SEB received a total of US$8.2m in redemption proceeds, via three separate payments.

Weavering's liquidators sought the return of these payments on the basis that they constituted preference payments in contravention of section 145(1) of the Companies Law. That provision provides:

145(1) Every conveyance or transfer of property, or charge thereon, and every payment obligation and judicial proceeding, made, incurred, taken or suffered by any company 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 the other creditors shall be invalid if made, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation.

At first instance the payments made to SEB were found to be preference payments, and SEB was ordered to repay them to the liquidators. SEB appealed to the CICA.

The appeal

The appeal was mounted on a number of different grounds. All failed.

1 Solvency

For a payment to be a preference it must be made at a time when the company is insolvent. SEB raised a number of technical arguments, asserting that the (in)solvency test was not met.

- **Fraud**

SEB argued that as a result of Mr Peterson's fraud, the Fund's net asset values (**NAVs**) upon which the calculation of redemption sums were based were not proper valuations in accordance with the Fund's constitutional documents and were thus not binding. As a result, there were no debts due to investors and, as a corollary, the Fund could not have been insolvent when the payments were made. The CICA rejected this analysis, and concluded that, notwithstanding Mr Peterson's fraud, and its effect on the Fund's NAVs, those NAVs were binding. In doing so the CICA followed the rationale set out in the Privy Council's decision in *Fairfield Sentry*.[2] The CICA however refused to apply the distinction between 'internal' and 'external' fraud enunciated by Jones J in *Primeo Fund v Pearson*,[3] and the consequences this may have on the contract between a company and its members.[4]

- **30 day payment period**

The Fund's offering memoranda provided that redemption payments would generally be made within 30 calendar days following the relevant redemption day. SEB sought to argue that the effect of this provision

[2] [2014] UKPC 9.

[3] [2015(1) CILR 482].

[4] A copy of our briefing note on Jones J's decision in *Primeo* can be found [here]. A copy of our briefing note on the Court of Appeal's decision can be found [here].

was to give the Fund a 'grace period' such that its obligation to pay redemption proceeds did not arise until this period had expired. In doing so, SEB argued that in relation to the payments which were made by the Fund on 19 December 2008, given sums due to the December Redeemers were not then due (ie a period of 30 days was still yet to pass from the 1 December redemption day), those sums were not debts which were capable of rendering the Fund insolvent. In rejecting this argument, the CICA held that the 30 day period as set out in the offering memoranda was merely a practical matter and did not affect the redemptions from becoming debts of the Fund as and from 1 December 2008, and thus were debts which were required to be taken into account when determining the question of the Fund's solvency.

- Future debts

The test for insolvency in the Cayman Islands is the cash flow test, ie whether a company can pay its debts as they fall due (as opposed to a balance sheet test). SEB sought to argue that this means that only debts which have actually fallen due for payment can be taken into account when determining whether a company is solvent on any given date, and that future debts are irrelevant. The CICA rejected this analysis, holding that the cash flow test in the Cayman Islands is not confined to consideration of debts that are immediately due and payable, and that it also permits consideration of debts that will become due in the reasonably near future.

2 Dishonesty

SEB argued that it is necessary that an intention to prefer within the meaning of section 145(1) must carry with it a 'taint of dishonesty'. This was based on a quote taken from the English Court of Appeal decision of *Re Kushler*.[5] While it is true that *Kushler* does refer to a taint of dishonesty as part of the enquiry into whether there exists an 'intention to prefer' within the meaning of the statute, the CICA did not consider actual dishonesty a necessary ingredient. This conclusion was reached by placing the reference in *Kushler* into its proper context: preference payments are by their nature contrary to the general principle of a *pari passu* distribution of an insolvent estate, and that although earlier statutory avoidance provisions were couched in terms of 'fraudulent preference', 'fraud' in this context did not mean actual fraud. Rather such terms, and the notion of dishonesty, merely reflected the principle that one creditor should not be given an advantage over another, and the court was not imposing a requirement to show actual dishonesty. The CICA thus rejected SEB's argument that it was necessary for the liquidators to demonstrate dishonesty on the part of Weavering when making the payments.

3 Nature of the cause of action and defences

Unlike its counterpart under the English Insolvency Act, section 145(1) does not provide a statutory direction for the return of payments (or other relief) which are found to have been made in contravention of it. It merely states that the payments are invalid. What then is the actual cause of action to be asserted by a liquidator to recover such payments? SEB argued that in the absence of a specific remedy, it is necessary for a liquidator to assert a claim for restitution. If this were correct, this would, in turn, enable the recipient of a payment caught by the provision to raise common law defences – such as change in position – in response to an action brought by a liquidator seeking its return. The CICA rejected this argument. Although section 145(1) is silent on the consequences of avoidance, the CICA held that payments made which are contrary to section 145 are automatically avoided, requiring the recipient to return the funds as a consequence of the section itself. In so doing, the CICA specifically rejected the availability of common law defences to a claim brought under section 145(1).

4 Comment

Although these proceedings were primarily concerned with the question of preference, it is the ancillary issues which the CICA was forced to deal with which are of particular interest, and which will no doubt be at the centre of the academic critique which will inevitably follow.

The CICA's determination that the cash flow test for solvency is not confined to debts that are immediately due and payable makes both commercial and practical sense, and ensures that conclusions about a company's solvency are not drawn on an artificial basis. It also confirms that the position in the Cayman

[5] [1943] 1 CH 248.

Islands is consistent with that in England, as stated by Lord Walker in BNY *Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc*,[6] and that the words as they fall due within the meaning of section 93 do not add anything of substance to the actual enquiry. As to what future debts are to be deemed as falling due in the 'reasonably near future', that is a question to be determined on a case by case basis depending on all of the circumstances, and with reference to the underlying business of the company.

Moreover, there are currently a number of liquidations of Cayman Islands investment vehicles where liquidators are being required to consider questions of rectification of the company's register of members, restatement of its NAVs, the consequences of fraud, and the ranking of claims by members and former members within the liquidation. The CICA's decision will now likely bear heavily on these considerations, particularly in light of the its rejection of Jones J's dual approach (set out in *Primeo*) to the consequences of fraud depending on whether the relevant fraud is 'internal' or 'external' to the particular company.

Mourant Ozannes partner Shaun Folpp appeared for Weavering's liquidators at both first instance and on appeal, led by David Lord QC (at first instance) and Jeremy Goldring QC (on appeal). He was assisted by senior associate Tina Asgarian.

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[6] [2013] 1 WLR 1408.