

Investment Fund Clawback Claims in the Cayman Islands



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A payment to a related party is deemed to have been made with a view to preferring that related party.

The leading decision of the Judicial Committee of the Privy Council (“UKPC”), Cayman’s highest appellate court, in *Skandinaviska Enskilda*

Banken AB (Publ) v Conway and another (as Joint Official Liquidators of Weaving Macro Fixed Income Fund Ltd), found that for there to be a preference, the payment in question must have been made with the *dominant intention to prefer*. Such an intention can be inferred from the evidence and it is not necessary to demonstrate fraud or dishonesty on the part of the company.

Nevertheless, the short time period for claims, and the requirements to show that the company was unable to pay its debts on a cash flow basis at the time of the disposition and that there was a dominant intention to prefer the creditor, mean that in practice few claims are brought.

Dispositions made at an undervalue

A disposition of property at an undervalue with intent to defraud creditors is voidable at the instance of its liquidator. *Disposition* is defined widely, and *intent to defraud* means an intention wilfully to defeat an obligation owed to a creditor. The liquidator bears the burden of proof and no action may be brought under this section more than six years after the date of the disposition.

Fraudulent trading

A liquidator may apply to the court for a declaration where it appears that any business of the company has been carried on with the intent to defraud creditors of the company, or creditors of any other person or for any fraudulent purpose, and any persons who have knowingly engaged in fraudulent trading may be ordered to make a contribution to the company’s assets.

Introduction

Attempts to claw back moneys into a liquidation estate feature commonly in insolvency procedures around the world. Following the Global Financial Crisis of 2008, many high-profile claims were pursued, perhaps most notably in the Madoff liquidation, where the Trustee appointed in the United States has had considerable success, eventually clawing back around US\$14.364 billion.

Many investment funds use offshore structures, with the Cayman Islands being the dominant choice. This article considers clawback claims in the context of investment funds set up in the Cayman Islands, although similar remedies are available in other offshore jurisdictions. The Cayman Islands is regularly used by sophisticated commercial parties and, perhaps unsurprisingly, its courts have tended towards upholding legal agreements and providing certainty.

Statutory clawback claims

The relevant statutory clawback claims are set out in relation to corporate entities in the Companies Law (2020 Revision) (the “**Law**”) but also apply to LLCs, partnerships and LLPs.

Voidable preference claims

Payments made in favour of any creditor, at a time when the company is unable to pay its debts, and within the six months immediately preceding the commencement of the company’s liquidation, are invalid if made with a view to preferring a creditor over other creditors. Whether a company is able to pay its debts is judged on a cash flow basis, although some regard must be had to claims falling due in the reasonably near future.

The requirement to prove fraud represents a high hurdle from the perspective of a liquidator. In practice, it limits the frequency of claims being made for dispositions at an undervalue or fraudulent trading.

Tortious clawback claims

As in England and Wales, the Cayman courts recognise a number of equitable doctrines, which have been used by liquidators as part of efforts to realise assets for the benefit of the liquidation estate. The key relevant claims are:

Knowing receipt

The plaintiff must show (i) a disposal of its assets in breach of fiduciary duty; (ii) the beneficial receipt by the defendant of assets belonging to the plaintiff; and (iii) knowledge on the part of the recipient that the assets he or she received are traceable to a breach of fiduciary duty.

Conspiracy

The tort of conspiracy requires an agreement (which need not be a contractually-binding agreement) between two or more people to do an unlawful act (or a lawful act by unlawful means) which causes damage to the plaintiff. Lawful means conspiracy requires a predominant intention to injure the plaintiff but, for unlawful means conspiracy, it is sufficient to show that the conspirators intended to injure the plaintiff.

Constructive trust

A constructive trust arises by operation of law whenever the circumstances are such that it would be unconscionable for the owner of the property in question (usually but not necessarily the legal estate) to assert its own beneficial interest in the property and deny the beneficial interest of another.

However, because it can be difficult to demonstrate the requisite knowledge or intention, it can be difficult to succeed with these causes of action.

Other attempts to clawback or alter creditor and shareholder claims

Some liquidators have sought to rely on other statutory provisions with a view to making recoveries or distributions on a basis that they regard to be fairer than that which would otherwise occur in accordance with a parties'

strict legal and/or contractual rights. The cases have tended to be in the context of investments in funds which have been impacted by frauds, and the attempts to depart from the parties' legal rights have generally failed.

Recovery of unlawful payments

The UKPC decision in *DD Growth Premium 2X Fund (In Official Liquidation) v RMF Market Neutral Strategies (Master) Limited* provides some clarity on the recovery of unlawful payments.

Redemption proceeds had been paid from the company's share premium account to the investor, RMF, and the issue was whether section 37(6) of the Law, which prohibits payments out of capital by a company that is insolvent, provided a basis on which the payments could be recovered.

The UKPC found that payment out of 'capital' under section 37(6) included payment made from a share premium account, thus rendering such a payment automatically unlawful if made at a time when the company was unable to pay its debts as they fell due. Despite this finding, the UKPC held that the payments to RMF were irrecoverable as a claim of unjust enrichment. Since the claim related to redemption proceeds for shares which had been redeemed and cancelled, the court held that there was a valid debt owed to RMF and that there was not, therefore, any unjust enrichment by virtue of the payments.

The UKPC acknowledged that a payment made in breach of the directors' fiduciary duties could potentially give rise to a knowing receipt claim, but this would require RMF to have knowledge that the payment was unlawful so as to become constructive trustee of the funds. In this regard, the UKPC noted that "*knowledge, especially in relation to apparently routine transactions where lawfulness depends on the internal affairs of the company, may be hard to prove*".

Redeemed but unpaid investors

In *Pearson v Primeo*, Primeo Fund (in official liquidation) sought confirmation as to its status in the liquidation of Herald Fund SPC, after submitting a redemption request shortly before Herald suspended the determination of its NAV and the payment of redemption proceeds.

The key question before the UKPC was whether Primeo's shares fell within the remit of section 37(7), such that they could only be redeemed where (i) the relevant terms provided for the redemption to take place at a date earlier than the commencement of the winding-up; and (ii) the fund could have lawfully distributed the redemption proceeds prior to the commencement of its liquidation.

Primeo argued that its shares had been redeemed prior to the suspension of redemptions and subsequent winding-up, in accordance with Herald's articles of association, meaning that section 37(7) of the Law was not engaged because it was concerned with shares which had not already been redeemed.

The Additional Liquidator for Herald argued that 'redemption' in the context of section 37(7) meant the entire process of redemption, including payment, and therefore Primeo's shares had not been redeemed and fell within the section.

The UKPC found for Primeo, and upheld the lower courts' decisions in finding that payment of redemption proceeds is "*clearly not an inherent element of the redemption and instead, the essence of redemption is... the surrender of the status of shareholder, with all attendant rights*".

Share rectification

The scope of a liquidator's power to rectify a share register was considered in the most recent litigation in *Pearson v Primeo*.

The Additional Liquidator of Herald wished to depart from the typical distribution method based on an investor's shareholding and instead make distributions based on an investor's net cash investment. The latter reflected the method applied by the US Trustee under the (United States) Securities Investor Protection Act in the liquidation of Bernard L Madoff Securities. It was common ground that Herald was itself not implicated in the Madoff fraud and that Herald's contractual obligations were not vitiated by fraud.

The Additional Liquidator of Herald sought to argue that section 112(2) of the Law, which allows liquidators to rectify a company's register of members in certain circumstances, conferred on a liquidator broad discretionary power to adopt any method of distribution as long as they were satisfied that it would produce the fairest outcome. The UKPC unanimously rejected this interpretation of section 112(2) of the Law, finding that rectification involved ensuring that pre-existing legal rights were respected rather than varied.

Conclusion

There are a variety of possible clawback remedies available in the context of investment fund liquidations, but experience in the Cayman Islands suggests that it can be difficult to succeed on these claims. The courts have generally sought to protect the legal rights of investors and uphold the contractual bargain that was struck. 🚫

