Conyers Dill & Pearman

OFFSHORE CASES

NOVEMBER 2014

CAYMAN ISLANDS

GRAND COURT

RMF Market Neutral Strategies (Master) Limited -v- DD Growth Premium 2X Fund (In Official Liquidation) (17 November 2014)

INSOLVENT HEDGE FUND COMPANY - PAYMENTS MADE TO INVESTOR FOR REDEMPTION OF SHARES - WHETHER PAYMENTS MADE FROM CAPITAL - WHETHER PAYMENTS RECOVERABLE BY THE LIQUIDATORS FOR BEING FRAUDULENT PREFERENCES

In the case before the court, the net asset value ("NAV") of DD Growth Premium 2X Fund (the "Fund") had been struck on the basis of a valuation of certain assets which turned out to be worthless, the NAV had therefore been so overstated that when the assets were realised there was a shortfall resulting in the Fund being unable to pay redemptions in full. Full redemption payments had been made to some redeeming investors, partial payments to others (including the Plaintiff) and no payments at all to others. The Fund was subsequently wound up and liquidators appointed by the court.

The liquidators sought to recover the payments made to investors whose shares had been redeemed on the basis of the overstated NAV, arguing that such payments were unlawful by reason of Section 37(6)(a) of the *Companies Law*, which provides: "*A payment out of capital by a company for the redemption or purchase of its own shares is not lawful unless immediately following the date on which the payment out of capital is proposed to be made the company shall be able to pay its debts as they fall due in the ordinary course of business*".

The Chief Justice of the Cayman Islands examined the capital maintenance doctrine as reflected in Section 37(6)(a), and then considered whether the payments made were payments out of capital. He held unequivocally that they were not.

The mainstay of the Chief Justice's reasoning is that save for a *de minimis* amount of US$1/1000 per share, the purchase price of the Fund's shares represented share premium, and the redemption price of the shares represented share premium plus (or minus) the profit (or loss) on the investment of that share premium (in this case into a similarly named master fund). Section 34(2) of the *Companies Law* provides what share premium can be used for and specifically authorises the use of share premium to be used for "*providing for the premium payable on redemption or purchase of any shares of the company*".

Accordingly, share premium was not to be regarded as having become part of the paid up share capital of the Company for the purposes of the capital maintenance rule as embodied in Section 37(6)(a).

The liquidators had sought to argue that under the 2007 Revision of the *Companies Law* (applicable at the relevant time) Section 37(5)(a), no reference was made to "share premium" (unlike the *2011 Amendment Law* which added such a reference). Therefore, they argued that share premium was, under Section 37(5)(b), deemed to be capital for the purposes of Section 37(6)(a). The Chief Justice described this as a "*strained and tortuous construction*".

The Chief Justice expressly rejected an argument that because changes to the wording of Section 37(5)(a) were made in 2011 to include the words "share premium" in that provision, a change in the law had been made so that prior to 2011 share premium was to be treated as capital. As the Chief Justice observed, there was no policy change that would justify such a conclusion. The 2011 Amendment served to clarify the existing law and not to alter it.

He held that Section 34(2)(f) was to be read without being limited by Section 37 and that there were in effect two separate regimes: that provided in Section 34 and that provided in Section 37. This conclusion was supported by the fact that Section 34(2)(c) provided for share premium to be used "in the manner provided in Section 37" in addition to providing by Section 34(2)(f) that it could be used for providing the premium on redemption. Thus, there was no prohibition on using share premium for the purposes of redeeming shares, even if a fund is cash flow insolvent at the time it makes those redemptions.

In the alternative, the Liquidators had argued that the payments were a fraudulent preference contrary to Section 168(1) of the *Companies Law* which requires the payments to be have been made "*with a view to giving such creditor a preference over the other creditors*". It has been held previously in the Cayman Islands that this requires the liquidators to prove that the "*dominant intention of the debtor was to prefer the creditor*".

On the evidence, the Chief Justice found that the liquidators had failed to prove such a dominant intention: indeed, on the contrary, he held that the payments were made due to the increasing pressure being exerted by the Plaintiff (including unannounced visits to offices and threats of reporting to authorities) and a desire to cover up or postpone the discovery of the catastrophic losses suffered by the Fund.