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Options for BVI Hedge Funds Fearing a Rush of Redemptions in Light of the COVID-19 Pandemic

Author: Eric Flaye, Associate

COVID-19 is having a widespread impact on financial markets and the global economy as businesses struggle with the disruption caused. Falling values across various asset classes are likely to reduce the overall net asset value of many hedge funds with net long positions. Investors may seek to redeem their investments in order to fulfill their own financial commitments and/or because of loss of confidence in the fund. This may lead to a rush of redemption requests and funds being unable to meet redemption requests in the usual way. A difficult balance may need to be struck between protecting the rights and interests of individual investors whilst trying to maintain the value and future viability of the fund for the benefit of the broader investor base. This article discusses some of the options available to BVI hedge funds facing a run on redemptions.

Background

Hedge funds are collective investment vehicles which pool subscription capital from investors and invest it according to a particular investment strategy or strategies. Many hedge funds are organised as two or three-tier structures (feeder funds and master funds) with the offshore fund vehicles incorporated primarily in the British Virgin Islands or the Cayman Islands (sometimes with an onshore feeder fund, such as a Delaware limited partnership, for a US investor base). The investors enter the structure through the feeder funds, which in turn channel funds into the master fund which makes the underlying investments.

When financial markets crash (as in 2008), or suffer significant losses, investors may seek to redeem their investments in the feeder funds for a variety of reasons including: fulfilling their own financial commitments, cutting their losses following a loss of confidence in the fund, investing elsewhere and changing investment strategy. This can put immense pressure on the fund as it struggles to maintain its value and future viability when experiencing a run of redemption requests. Investors who elect to redeem out of the fund generally rank as creditors of the fund during the period between redemption of their fund interest and payment of the redemption proceeds. As creditors of the fund they rank above the other remaining investors (who rank as shareholders), and the fund may face being wound up.

There are a range of options available to hedge funds with their offshore companies incorporated in the British Virgin Islands. The first point to note is that the company's articles of association will set out the particular basis on which its shares may be redeemed and there are also statutory limitations on the process. This article is not an exhaustive guide to every particular process as each company's constitutional documents will have to be reviewed in detail on a case-by-case basis and the statutory rules applied. Urgent legal advice should be sought in all instances in which a fund faces (or anticipates that it may soon face) a litany of redemption requests. Here we set out some options that have been commonly used by BVI hedge funds facing a rush of redemption requests.

Limiting or suspending redemptions and gating

One option, often viewed as drastic, for a fund dealing with a high volume of redemption requests, is to suspend calculation of the fund's net asset value ("NAV"). This effectively suspends redemptions as until the NAV is calculated there is no ability to calculate the amount due to a redeeming investor. Again, the ability to do this, and the legal effect of such a suspension of NAV, depends on the constitutional documents of the fund. Suspending calculation of NAV has disadvantages. Understandably it is generally very unpopular with those investors who wish to urgently redeem out of the fund (although some investors may actually expect a prudent and well-advised fund manager to invoke a suspension or gate when reasonably necessary to protect the interests of investors taken as a whole). In addition it means that new subscriptions cannot be accepted during this time and the fund may experience damage to its reputation.

Depending on the specific terms of the fund's constitutional documents, it may be possible to suspend redemptions independently of suspension of calculation of NAV. A further option is to process redemption requests, but suspend payment/settlement of redemption proceeds. This is another seemingly unpopular scenario (at least insofar as investors are concerned), but when the market crashed in 2008, some funds that had suspended redemptions early and waited for the situation to improve before lifting the suspension managed to weather the storm and survive.

Many funds also have the ability to impose redemption gates (assessed either on an individual investor or whole of fund basis). Such gates operate to restrict the amount and/or timing of redemptions. A typical fund-level gate restricts the amount that can be redeemed as of a particular redemption date to a percentage of either the total shares in issue or the NAV of the fund. Imposing gates can however lead to a flurry of urgent redemption requests because as soon as a gate is imposed it may establish a priority among investors who have decided to redeem. Gates can therefore encourage investors to redeem early through fear of being last in line. The extent to which and how a fund can suspend redemptions or impose gates is set out in the fund's constitutional documents.

If a fund fails to suspend NAV, suspend redemptions and/or impose a gate in a timely manner, it may be left with a pool of redeemed but unpaid (and therefore aggrieved) investors. If redemptions are processed, but redemption proceeds not yet paid (assuming the fund has not suspended redemption payments in accordance with its constitutional documents), the unpaid investors become creditors of the fund, and in that new capacity may petition for the fund to be wound up. Timing is therefore critical.

Restructuring options

Rather than suspending redemptions or imposing gates, funds may seek to restructure their assets to provide alternative solutions for investors wishing to redeem, without destabilising the fund or prejudicing the remaining investors. Side pockets and *in specie* distributions are popular options.

Side pockets

Side pockets are typically used to differentiate liquid and illiquid investment holdings of a hedge fund. Once a side pocket is created, and an investment enters that pocket, only current investor (and not any future investors) in the fund are entitled to a share in it. Whether a fund has the ability to put specific assets into a side pocket is determined by its constitution. Typically one would expect the directors to have discretion in this regard as side pockets are a useful portfolio management tool that can offer measurable benefits to both investors and fund managers.

However, side pocket provisions are less common in smaller emerging funds with more basic and simple fund documentation. A side pocket is simply a separate bookkeeping account used by a fund to segregate illiquid or difficult to value assets, for the purpose of preventing those assets from damaging the returns generated by other more liquid portfolio holdings and minimizing the risk of unfair treatment of investors which may result from difficulties in accurate valuation. Critically, side pocket assets are not generally subject to elective redemption by investors, and investors' interests in the side pocket may only be redeemed as or when the assets making up the side pocket are realised. Therefore side pockets may provide valuable flexibility for a fund manager to isolate specific illiquid investments until market conditions improve, in the hope that such assets can be realised for a better price.

An example, however, of a side pocket creating problems is the Cayman case of *FIA Leveraged Fund v. Firefighters' Retirement System (CICA Unreported, February 2013)*. Here the investment manager sought to satisfy a redemption request by hiving off highly illiquid assets of the fund into a new company and issuing shares in the new company to its redemption creditors by way of an *in specie* distribution. The manager argued that this was permissible pursuant to the articles of the fund.

The redemption creditors sought to wind up the fund on the grounds that the distribution of shares in the newly formed company was illegitimate, and consequently a debt remained due from the fund, and on that basis it could be shown to the Court that the fund was insolvent. The redemption creditors obtained a winding-up order before the Grand Court in a decision that was subsequently upheld by the Cayman Islands Court of Appeal. The Court of Appeal rejected the argument put forward by the company that the creation of the side pocket and distribution of shares was a valid *in specie* redemption because the shares of the new company had not been an asset of the fund as of the redemption date. On a proper construction of the articles, the Court held that in order to effect an *in specie* distribution, the fund must have owned the asset to be distributed *in specie* on the redemption date.

This Cayman case demonstrates the importance of seeking timely advice on the particular terms and conditions of constitutional documents when a fund is considering its options and its ability to create a side pocket.

In specie distribution

The documentation of some funds does not allow them to set up side pockets but there may be other options available.

“Redemptions *in specie*” allow a fund to make distributions in kind (by distributing interests in the investment holdings of the fund) rather than in cash. For example, if a fund holds shares in a particular asset, it might transfer some of those shares to the investors, as opposed to selling the shares and distributing the cash proceeds. Any *in specie* distributions must be made in accordance with the particular terms of the fund’s constitutional and offering documents.

More generally, the key takeaway from relevant BVI case law in this area (such as *Citco Global Custody NV v. Y2K Finance Inc.* BVIHCV 2009/0020A, *Headstart Class F Holdings Company Limited and Citco Global Custody NV v. Y2k Finance Inc.* BVIHCV 2008/0278, *Re: Livingston International Fund Ltd. (In Liquidation)* BVIHCV 2002/0197 and *Professional Offshore Opportunity Fund Limited v. Daiwa Securities* BVIHCV 2009/0006) is the critical importance of timely compliance with the specific terms and conditions of a fund’s constitutional and offering documents. Key considerations when devising a strategy to deal with a potential rush of redemption requests, to be assessed on a case-by-case basis, include:

- Redemption days and notice periods
- Ability for the fund to suspend calculation of NAV, suspend redemptions (independently of suspension of calculation of NAV) and/or suspend payment of redemption proceeds
- The point in time a redeeming investor will become a creditor of the fund (generally a redeeming investor becomes a creditor if the relevant redemption date passes before any suspension is declared but the constitutional documents may potentially provide otherwise) and cease to have rights as a shareholder of the fund
- Ability for the fund to impose a gate
- Ability for the fund to create side pockets
- Ability for the fund to settle redemption proceeds in kind (and create liquidating accounts/ SPVs for this purpose)
- What investor notification and timing considerations apply.
- Any investor side letters of potential relevance

BVI case law in this area reveals that legal disputes tend to arise from failure to comply with the particular procedural and other requirements set out in the fund’s constitutional and offering documents and/or failure to act quickly. Detailed and carefully crafted board minutes are also very important to document due process.

Dealings with the BVI Financial Services Commission

The BVI Financial Services Commission should be promptly informed of (and then kept abreast of any further material developments in respect of) any suspension or gate imposed by a BVI hedge fund.

For example, BVI Approved Funds and Incubator Funds are required (in accordance with the Securities and Investment Business (Incubator and Approved Funds) Regulations, 2015) to “*notify the Commission of any matter in relation to the affairs (including the conduct of business) of the incubator fund or approved fund which has or is likely to have a material impact with respect to the incubator fund or approved fund*”.

Conclusion

Readers will note that there are a variety of tools potentially available to navigate the rocky road of a pending rush of redemptions and that the constitutional documents of the fund are key. Therefore seeking legal advice at an early stage is crucial. Advice may be needed generally regarding restructuring options, preparing a strategy, board meetings (and the importance of documenting the same), issues concerning the resignation of independent directors and, perhaps, placing the company into liquidation and whether provisional liquidation is possible. Directors may also wish to seek independent advice on compliance with their own duties. If there is going to be a rush on redemptions, creating an effective strategy ahead of time is going to be critical for the survival of the hedge fund.

Author:

Eric Flaye
Associate
eric.flaye@conyers.com
+44 (0) 207 562 0341

Other Contacts:

Robert J.D. Briant
Partner, Head of BVI Corporate
robert.briant@conyers.com
+1 284 852 1119

Anton Goldstein
Partner
anton.goldstein@conyers.com
+1 284 852 1100

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For further information please contact: media@conyers.com