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# The Cayman Islands Court of Appeal affirms liquidators' clawback powers

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When a fund fails, the disappointed investors' sole hope of recompense often rests on the fund's liquidators gathering in and distributing pari passu as many of the fund's assets as possible. The judgment of the Cayman Islands Court of Appeal in Skandinaviska Enskilda Banken AB (Publ) v Simon Conway and David Walker (CICA 2 of 2016), delivered on 18 November 2016, clarifies aspects of the liquidators' power to claw back certain types of redemption payments made shortly prior to liquidation. The decision of the Court of Appeal is a welcome affirmation of the public policy of pari passu distribution of the assets of an insolvent estate, which underpins the whole Cayman Islands insolvency regime.

## Background

Skandinaviska Enskilda Banken AB (Publ) (the "Appellant"), subscribed for shares in Weavering Macro Fixed Income Fund Limited ("Fund") as custodian for a number of ultimate beneficial owners. Beginning in October 2008, the Fund began receiving large volumes of redemption requests, among them, two requests from the Appellant for redemption of its entire shareholding.

Unbeknownst to the redeeming investors, by late 2008 the Fund's NAV was in fact almost wholly fictitious, having been inflated by sham interest rate swap transactions ("Swaps") which the Fund's principal investment manager, Magnus Peterson, procured the Fund to enter into with one of Mr Peterson's own companies. The counterparty being effectively without assets, the Swaps were worthless in the hands of the Fund.

Nevertheless, the Fund paid the Appellant under its first redemption notice in full in December 2008. The Fund paid the Appellant under its second redemption notice in two tranches: 25% in January and 75% in February 2009. Certain other investors who submitted redemption requests were paid out alongside the Appellant, some in full and some in part only. Many more investors who also submitted redemption requests were never paid out at all, as the Fund ran out of cash and was unable to realise any value from its fictitious Swaps. The Fund entered official liquidation in March 2009.

## The court of appeal's decision

The Joint Official Liquidators ("JOLs") of the Fund (PwC and Grant Thornton) brought claims against a number of the investors who were paid out in full or in part between December 2008 and February 2009, including the Appellant. The claims were brought on the basis that the payments were voidable preferences under s. 145 of the Companies Law (2013 Revision), which, in summary, provides that a transaction shall be invalid if it is made:

- within six months preceding the commencement of liquidation;
- at a time when the company is unable to pay its debts; and
- with a view to giving the receiving creditor a preference over other creditors.

The JOLs succeeded on their s. 145 claim at first instance, with Clifford J ordering the Appellant to repay over US$8 million in redemption proceeds to the liquidation estate. In a three-pronged attack on that decision of the Grand Court, the Appellant argued that:

- the Fund was not insolvent at the time of the payments to the Appellant, because, among other things, the Fund's NAV was a product of Mr Peterson's fraud and therefore not binding;
- payments to the Appellant were not made with a view to preferring it over other creditors of the Fund, because, among other things, such a finding cannot be made in the absence of a taint of dishonesty; and
- in any event, the Appellant should not be ordered to repay the funds to the liquidation estate, because it had a common law defence of change of position, and because the JOLs' claims were founded on Mr Peterson's fraud and were therefore contrary to public policy.

The Court of Appeal unanimously rejected all of these arguments and affirmed the decision of the Grand Court. In so doing, the Court of Appeal made a number of findings that helpfully clarify the scope of liquidators' powers under s. 145 when applied to clawing back redemption payments made by funds which collapse as a result of fraud. There are three key points of principle to take away from the appeal judgment.

First, the decision explains that there is no need for the redemption payment to have been tainted with any dishonesty for it to be recoverable under s. 145. This means that the liquidators do not need to prove any fraud or other dishonesty in the making of the redemption payment itself; only the intention to prefer the creditor over others needs to be proved. In the case of the Appellant, a formal policy of paying a particular class of redeemers ahead of others, which was recorded in a letter from the Fund to its investors dated 31 December 2008, was found by the Court of Appeal to be sufficient to establish the requisite intention to prefer the Appellant (as a member of that class of redeemers) to the other unpaid or partly paid redeemers.

Second, the decision clarifies that fraud does not affect the binding nature of the Fund's contemporaneous redemption obligations. The Appellant argued that, as the Fund's inflated NAV was a product of Mr Peterson's fraud and, in effect, a fiction, it was not binding on the Fund or on the redeemers, with the result that none of the redemption requests crystallised into binding liabilities of the Fund. If so, argued the Appellant, the Fund was not insolvent at the time it made the redemption payments to the Appellant, meaning that s. 145 was not applicable. However, the Court of Appeal rejected this argument, applied the principles in the Privy Council's decision in Fairfield Sentry[1] and ruled that the construction of the Fund's Articles of Association on this point had to be informed by the commercial need for certainty on a day-to-day basis as to the price at which shares in the Fund could be bought and sold. In those circumstances, said the Court of Appeal, the declared NAV remains binding as between the Fund and its redeemers even if it might be fictitious or tainted by fraud. While the point turned on construction of the Fund's Articles, it will likely be applicable to funds more generally.

Third, it is now clear that s. 145 is a complete and self-contained regime for clawing back preferential payments, without any need for the liquidators to resort to common law claims and without any opportunity for the defendants to raise common law defences. The Appellant argued that, because it held shares in the Fund as custodian for underlying beneficial owners, by paying the redemption proceeds onwards to its clients it acquired the benefit of the common law defence of change of position. The Court of Appeal ruled that the Appellant's status as custodian was irrelevant and that common law defences, including that of change of position, were not available in a claim under s. 145.

The Court of Appeal also dismissed any suggestion that where, as in this case, liquidators were bringing claims on behalf of an estate of a fund that collapsed due to fraud those claims were somehow tainted by illegality or contrary to public policy.

1 *Fairfield Sentry v Migani [2014] UKPC 9.*

Continued

## Comment

Following the rather creditor-unfriendly decision in DD Growth[2], which established that out-of-turn redemption payments made due to commercial pressure did not satisfy the test of intention to prefer in s. 145, the decision of the Court of Appeal should give creditors some comfort that s. 145 remains a credible weapon in the liquidators' arsenal. In particular, the unambiguous ruling that common law defences are unavailable in s. 145 claims should reduce the complexity and, therefore, the duration and cost of such claims. This is good news for creditors of insolvent funds, as well as for the integrity of the overriding public policy of distributing the assets of an insolvent estate pari passu among its creditors.

At the same time, the decision could be of concern for investors in Cayman Islands funds and, especially, for those whose business involves holding shares in funds as custodian for ultimate beneficial owners. The unavailability of common law defence of change of position means that such custodians face a six month exposure horizon on any redemption proceeds that they pass on to their clients.

Jan and Denis act for the JOLs in 19 other preference claims which had been stayed pending the Court of Appeal's decision in this case.


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2 *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund [2014] 2 CILR 316.*