- KENNETH M. KRYS

When funds fail

Kenneth M. Krys explains the complicated business of liquidating a Cayman Islands hedge fund.

Despite the wide spread publicity that the failure of some funds has attracted, in Cayman—where it is projected that in excess of 20,000 funds are registered or established—there have been relatively few true major 'failures'. But funds do fail. It is an inevitable consequence of taking risk.

This article looks at the issues that a liquidator of a Cayman fund faces once he is appointed. Commencing liquidation proceedings in Cayman increases the number of opportunities and options available for an insolvency practitioner (IP) in pursuing asset recoveries, whilst providing stability for creditors and investors, and giving them the opportunity to participate in the liquidation process. A Cayman liquidator will often have the opportunity to choose from more than one jurisdiction in which to seek discovery and pursue asset recovery actions, providing the Cayman liquidator with powerful tools to maximise asset recoveries to the estate.

THE QUESTION OF JURISDICTION

In Cayman, issues can arise as to governing law, in particular, in those instances where offshore funds have operations in the United States, and particularly where a US receiver has been appointed in the US. In May 2006, the Grand Court of the Cayman Islands considered this particular situation in the case of Philadelphia Alternative Asset Fund Limited ("PAAF"). A US-appointed receiver, appointed in 2005 by the US CFTC, attempted to be appointed liquidator of a Cayman Islands incorporated fund regulated in the Cayman Islands.

The US receiver tried to argue that the liquidation in Cayman served no practical purpose, and would be a duplication of costs and effort, as the receiver had already been recovering assets and was taking other steps to wind up the fund in the US. The US receiver also argued that any distributions would be made in accordance with Cayman law (application of US law would have caused prejudice to investors of the Cayman fund).

The Grand Court decided that the liquidators should be Cayman Islands practitioners, based on the fundamental legal principle that, when a company is incorporated in the Cayman Islands, Cayman Islands law will apply to its liquidation and that the best person to wind up a Cayman Islands fund would be a Cayman Islands practitioner with knowledge of Cayman law. This is not to say, however, that the Cayman Courts have no flexibility; in certain cases, the Courts have, in the past, granted joint appointments between a Cayman Islands practitioner and a foreign liquidator. The judge in the matter also added that investors had a reasonable and legitimate expectation that such a winding-up would occur in the Cayman Islands under Cayman Islands law.

RECOGNITION IN A FOREIGN JURISDICTION

The overwhelming majority of Cayman-incorporated companies do not conduct all of their business activities in Cayman and, therefore, a liquidator needs to consider its ability to gain recognition in other jurisdictions where it may require the assistance of the Courts in those jurisdictions to enforce its powers as liquidator.

The United Nations Commission on International Trade Law ("UNCITRAL"), in 1997, produced a set of provisions designed to assist with cross-border insolvencies by establishing the rights of access to courts in enacting states for foreign office holders. The US adopted the UNCITRAL model via Chapter 15 of the Bankruptcy Code through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Chapter 15 replaces Section 304 of the Bankruptcy Code.

The purpose of Chapter 15, and the model law on which it is based, is to provide effective mechanisms for dealing with cross-border insolvency cases involving funds, assets, claimants and other parties in interests involving more than one country. Through the recognition process, Chapter 15 operates as the principle door of a foreign representative to the US federal and state courts.

But getting recognition isn't always so easy. RSM sought such recognition in relation to our role as court-supervised liquidators of the SPhinX Funds. The SPhinX Funds are a group of investment vehicles that were designed to track certain Standard & Poor's hedge fund indexes. Each of the SPhinX Funds was organised and incorporated under the laws of the Cayman Islands, and the liquidators were subject to the supervision of the Grand Court of the Cayman Islands.

Although often such an application would be heard ex parte, in this case, notice was given to certain parties, who filed a joint objection to the recognition of the Cayman proceedings as foreign main proceedings. This was the first time an application for recognition under Chapter 15 had been challenged.

The primary issues in the hearing were the "center of main interest" (COMI) and the US Bankruptcy Court's discretion to consider other factors. And while the court appeared to be persuaded on the balance of probabilities that the Cayman Islands was COMI, it had concerns as to what impact the recognition as foreign main proceedings might have had on a related case before the same court and determined that the proceeding should be recognised instead as foreign non-main, thereby giving the liquidators none of the deemed relief afforded under Chapter 15. Not surprisingly, RSM appealed the decision.

Since the SPhinX decision, there has been justifiable cause for concern amongst Cayman Islands-based IPs with respect to the recognition of Cayman liquidations in the US, following the changes to the US Bankruptcy Code. Those concerns have since been ameliorated in part by the decision of the US Bankruptcy Court in the case of Amerindo Internet Growth Fund Ltd (in liquidation) on March 5, 2007, which had a stronger connection to Cayman. The decision is an important step towards restoring the *status quo* with respect to recognition of Cayman liquidations as foreign main proceedings under the US bankruptcy regime and should go a long way towards reassuring practitioners who may need to bring similar applications in the future.

ASSET RECOVERIES

The legislation that governs liquidation proceedings in the Cayman Islands is contained in the Companies Law (2004 Revision) and The UK Insolvency Rules 1986 ("the Rules") to the extent that the Rules are consistent with Cayman law. The law in Cayman is well established and predictable in its application. Liquidators appointed by the Court are given broad powers to carry out their duties, which include the power to bring legal proceedings, to carry on the business of the company, and to do and execute all such other things necessary for the winding-up of the company and the distribution of its assets.

Despite these broad powers, when dealing with fund failures, an IP often faces a number of practical and pragmatic concerns that he must address in order to comply with his fiduciary obligations and to maximise the returns to creditors and investors. Of all of these, the recovery of assets and the best means of pursuing them, including when, where and at what cost, is the most complex. Below is a discussion of some of these issues:

1. Statute of Limitations

In the Cayman Islands, the statute of limitations for pursuing claims is usually six years. In New York, for instance, the pursuit of claim may be statute barred as early as two or three years. Depending on how far back an IP needs to recover an asset or pursue a party that failed to comply with its fiduciary responsibilities, the choice of jurisdiction may be relevant.

2. The *in pari delicto defence*

The *in pari delicto* (Latin for "in equal fault") defence means that two (or more) people are all at fault or are all guilty of a crime. In the US, this defence is available to any defendant who has relied upon the party that committed the wrong, and in most cases where pursuit of service providers and/or auditors is being considered, it is one of the biggest issues to address prior to commencing litigation. In the Cayman Islands, this defence is not available to defendants.

3. Jury Trials

In the US, plaintiffs and defendants can request a jury trial. In recent years, there have been a number of public reports of the jury making large damage awards against deep pockets. Depending on whether the party feels that a jury will be sympathetic or not to its situation, one may or may not believe that a jury trial would maximise the asset recoveries. In Cayman, this option for civil matters does not exist.

4. Punitive and Special Damages

Punitive damages, also known as exemplary damages, are damages that are separate and in excess of the compensatory damages awarded to a plaintiff in a legal suit that arises from the malicious or wanton misconduct of the defendant. Punitive damages are imposed to serve as a punishment for the defendant and are a modern phenomenon of the US judicial system. In the US, punitive damages may be assessed in connection with nearly any type of commercial or personal activity. The ability to pursue such damages is more limited in Cayman.

5. Recognition, Registration and Enforcement of Foreign Orders

Registration and enforcement of orders depends on a number of factors. Therefore, when an IP is considering where to commence a recovery action, the IP will consider whether, to the extent there are believed to be assets outside of the jurisdiction, any order obtained can be recognised, registered or enforced in the jurisdiction where the assets exist.

TREATMENT OF CREDITORS AND INVESTORS

The treatment of creditors and investors—primarily whether there is consistency in the approach taken—is important. As discussed above, the legislation in Cayman is creditor-friendly. There is no time limit during the liquidation by which creditors must file a proof of claim, which in practice means that creditors can take their time to quantify and research the basis for their claims. Also, in Cayman, with the Insolvency Rules 1986 being the appropriate rules for determining how assets should be distributed, there is clarity in how creditors rank and the basis for distributing the assets.

ROLE OF THE CREDITORS COMMITTEE

Another interesting factor is the role of the creditors committee. In the Cayman Islands, a creditors committee comprising more than three but not more than five creditors must be convened. The committee acts in an advisory role to the liquidator, and supervises and assists the liquidator on behalf of the creditors. The Insolvency Rules 1986 place a positive obligation on the liquidator to report to the members of the liquidation committee all such matters that appear to him to be, or that they have indicated to him as being, of concern to them with respect to the winding-up. The committee is also responsible for reviewing the liquidator's fees; however, the Court retains the ultimate say in approval, and all fees for court-appointed liquidators must be approved by the Court.

CONCLUSION

There are a number of issues that a liquidator of a Cayman fund may face. A liquidator with experience will be able to navigate through the maze of potential problems, ensuring a speedy and efficient liquidation, thereby maximising the return to creditors and investors■

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