

Illiquid Investments in Cayman Islands Investment Funds

Keep Calm and Explore Your Options



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Some 11,000 investment funds are registered in the Cayman Islands, accounting for approximately half of the world's assets under management. When the 2008 financial crisis hit and global economies froze, approximately \$175 billion was trapped in Cayman Islands funds that had become illiquid. And although the amount is smaller today, it still hovers around \$60 billion.

Investors who fear their investments have soured are quite concerned. Today, some of those investors are losing patience and are increasingly opting to take costly legal actions to recover their funds. Legal recourse often involves petitioning Cayman Islands courts to place a fund into liquidation. If the petition is granted, the court will appoint an independent professional liquidator to sell or otherwise dispose of the fund's assets and return the proceeds to its creditors and investors. Unfortunately, some investors are taking this drastic step without first considering less costly and possibly more efficient avenues of resolution.

Part of the challenge involves a common misconception about the Cayman Islands. The British overseas territory generally is thought of as a hotbed of financial misdeeds hidden behind secrecy laws and weak corporate governance. Consequently, if troubles persist at a fund and communication to investors is poor, they may fear the worst and turn to the Cayman courts. Legal actions are on the rise. According to an FTI Consulting analysis of publically available petition filings, stakeholders brought as many liquidation petitions against Cayman Island investment funds

in the first six months of 2015 as they did in all of 2014.

This negative perception of governance in the Cayman Islands does not reflect reality. The Cayman Islands constitute a modern and sophisticated financial center, with a deep bench of experienced lawyers, accountants, independent directors, administrators and other investment fund specialists. As a British territory, the islands also have a sound regulatory, legal and court system. The ultimate court of final appeal is the Privy Council in England.

In fact, every year a large number of funds are wound down with little or no rancor or disagreement between investors and management. At the beginning of the global financial crisis in 2008 and continuing into 2009, for example, managers restructured many funds by, among other things, paying back investors with fund assets instead of cash. They also ring fenced illiquid assets in separate special purpose vehicles (e.g., side pockets) until market conditions improved and these assets could be sold.

In some cases, however, fund managers have caused frustration among investors by moving too slowly

and communicating too infrequently, contributing to the perception of a lack of transparency. This may be due to the fact that personnel changes occur over the years at most funds and that new individuals may be unfamiliar with the investments made by their predecessors and the options they chose to monetize the assets. Given the additional time and resources needed to find an appropriate exit, newer managers may have little incentive to make progress toward resolving investor concerns.

Confronted with this lack of attention, investors may be inclined to pursue resolution in the courts. Litigation is a serious step to take. For example, obtaining a winding up order to place a fund into liquidation requires that the fund must be either insolvent or that the liquidation is "just and equitable" because of alleged fraud, a lack of



management probity or the inability of a fund to achieve its primary investment purpose. In certain cases, the Cayman courts have taken the view that a fund should be liquidated because it no longer is practical to continue its investment business. In these instances, the funds had ceased to make any new investments and were winding down and monetizing the remaining investments. However, in other similar situations, the courts refused to appoint an independent liquidator because it considered the fund's investment manager or directors as best placed to extract the greatest value from the fund's portfolio.

Think Twice — and Then Think Again — Before Going to Court

The first question investors should ask when contemplating filing a winding up petition is whether legal action is even feasible. The constitutional documents of some funds may contain provisions that present obstacles that would prevent a successful legal action. Often the investors' due diligence processes did not focus on the best mechanisms to resolve issues and disputes should investments go south.

In a recent case, investors claimed that the fund's investment manager (and others with whom he was affiliated) were charging unjustifiable management fees that were draining the fund's assets. The investors, who were limited partners, wanted the fund liquidated. But the Cayman Islands court dismissed the petition because the fund's limited partnership agreement specifically prohibited such action. This decision is controversial, but the moral of the story is clear: Investors need to examine fully the terms of a fund's governing documents before taking any legal action.

Since the financial crisis, a large number of funds have updated their governing documents to define what should happen should a wind down become necessary. Typically, governing documents require that the process be conducted by the fund's managers and

directors rather than an independent liquidator. Although the Cayman Islands courts have broad discretion to determine if a fund should be liquidated, their hands may be tied if the current agreement specifies the who, when, why and how of liquidation. By the same token, agreements may include arbitration clauses or require other forms of dispute resolution instead of the Cayman courts.

Several steep legal hurdles also can stand in the way of putting a Cayman fund into liquidation absent insolvency. The burden of proof for a "just and equitable" petition is high, especially if the petition is based on allegations of fraud or mismanagement. Because liquidating a fund is a severe measure, the Cayman Islands courts will demand substantial, probative evidence. However, the governing documents for most funds do not require fund managers and directors to disclose detailed information to investors beyond periodic net asset value statements and annual audited accounts. When facing potential legal action, fund managers and directors usually are reluctant to share more information than is required, which makes it extremely difficult, or impossible, to amass sufficient evidence to satisfy a court.

Time is another issue. It can take a number of months to put a fund into liquidation, particularly if its board and management oppose the action. In such cases, investors may be hesitant to trust the fund's management and directors to continue in their roles pending the resolution of the action, especially if the issue is alleged mismanagement. However, the alternative — designating an interim provisional liquidator — can be costly and risky. To have the court name a provisional liquidator, investors must show that one is needed to mitigate management misconduct or to prevent dissipation and/or misuse of the fund's assets. Moreover, if the court dismisses the petition and the fund suffers losses because of the legal action, the court may demand that the petitioning investor pay damages, which is the price of appointing liquidators provisionally.

Finally, investors have to demonstrate that they have something to gain. In order to place a fund into liquidation,

Investment Managers Take Notice

When investor angst mounts, swift and transparent actions by fund managers can calm the situation and produce an environment that fosters collaboration. If managers take investor patience for granted, fail to address shareholder concerns in a timely manner or withhold pertinent information, they simply will create more distrust, leading investors to attempt to take matters into their own hands through extreme measures.

If liquidity is the principal issue, investment managers should explore potential asset sales. There is a healthy secondary market for all classes and sizes of assets, even those that are illiquid, with cash-rich and sophisticated buyers chasing relatively few opportunities. The market will seek to discount illiquid assets, which could reduce the pool of money for investors, but this may be a better solution than sitting in a long holding pattern or being brought to court.

Managers also can turn to the secondary market, and even to the fund's investors, for lending. Both may seriously consider making loans against assets to improve liquidity, as opposed to selling the assets and accepting losses. Secondary market players can be creative in how they earn their returns. Deal structures are a blank page that can be filled according to the requirements of the situation. Nonetheless, borrowing when in distress is likely to be expensive and should be considered only in circumstances where it is in the best interests of the fund's investors.

investors must show that they would have a tangible financial interest in the outcome should the fund be liquidated. Meeting this requirement can be difficult if asset values are uncertain and there are additional more highly ranked creditors, such as lenders, or other significant liabilities.

A Better Way: Resolving Issues out of Court

Although there is no denying that some fund managers are bad actors, a far greater number are credible and will listen to investor issues and will entertain shareholder suggestions. As a result, resolving matters *outside* of court, rather than *through* it, can be far more efficient, cost-effective and reliably less risky.

For example, investors can request that the fund hire an independent third party such as a professional restructuring advisor to assess the fund's situation and develop specific solutions. The advisor's analysis and recommendations can include possible refinancing strategies, independent fee and expense calculations and assessments, and cash flow projections. An independent advisor also may bring fresh eyes to how assets can be disposed of most effectively and profitably.

Naming a wind-down specialist to the fund's board is another possible path to pursue. Appointing a specialist requires that investors have voting rights or, if not, that they have other sources of influence. For example, if a fund is in need of a cash infusion, investors can agree to provide it on the condition that the fund expands their rights to include the ability to designate an independent advisor or director.

In a surprising number of cases, investors do not realize that their shares have voting rights. We know of several

instances where investors not only had voting shares but had enough leverage to call for an extraordinary general meeting and the removal of a board. After the board is removed, or changed, investors can threaten to terminate — or terminate — the investment management agreement. Short of that, boards usually have the right to override a fund manager's decisions.

Finally, to help support the fund, investors can ask the directors to renegotiate agreements with service providers. In some circumstances, the directors may be willing to assess the fund's fee structure to determine if it still is appropriate.

If All Else Fails

Although taking legal action always is a drastic move, it sometimes is necessary. But before taking that step, investors should make diligent efforts to resolve the issues out of court. Amicable solutions, many times, can be found. And even if they can't be, the attempt will provide useful evidence in any litigation and will help persuade a court to grant the remedy investors are seeking.

For example, investors in a closed-end fund (a fund that has a finite period for investment) had heard no word about their investments as the date passed for the assets to be returned. The situation was serious. For eight years, the fund had had no independent audit. The auditors hired by the fund had run into so many roadblocks that they finally gave up. Investors were receiving information only sporadically because the fund had

ceased paying its administrator, who then stopped preparing net asset value statements. What financial information investors did get led them to believe that the value of their assets was dissipating. To top it off, the fund had no independent directors providing oversight for investors.

To protect their interests, the fund's investors decided to collaborate and work with the fund's manager to address their collective concerns. The investors found each other through the brokers who had sold each investor his or her investments. These investors then formed an action group with a legal representative. The group proposed several solutions to the fund manager, including either the appointment of an independent advisor or an ad hoc oversight committee of investors.

Despite their efforts to be reasonable, the fund manager continued to ignore the investors' requests. However, the group members had a paper trail that made it clear to the court that they had exhausted all other means and that a petition to place the fund into liquidation now was their only recourse. When confronted with the overwhelming evidence the investor group presented, the fund's management did not oppose liquidating the fund, which the court then ordered.

Investors can do a great deal to protect themselves when investments in Cayman Islands funds run into trouble. Going to court to have the fund liquidated is one course of action. But before taking that route, investors need to understand the legal landscape fully and attempt to determine whether they can successfully pursue legal action. Even if they can, litigation always should be a last resort. The best scenario, absent fraud or wrongdoing, is to work with the investment manager and directors to find an adequate solution. More often than not, fund managers will cooperate, and the issues can be resolved to the satisfaction of all parties. ■

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