

## **WHEN IS A REDEMPTION NOT A REDEMPTION? Cayman Mutual Fund Redemptions after *Re Strategic Turnaround Master Partnership, Limited***

One thing most investors want to know is how to get out of an investment, particularly with the looming prospect of increased regulation, and against a backdrop of ongoing global economic crisis and scandals such as the Madoff affair.

Shareholders of companies might be forgiven for thinking the answer is obvious: “Redeem your shares!” This is, of course, true, but submitting a redemption request to a Cayman Islands-incorporated company is just the start of what could be a surprisingly long process of ceasing to be a shareholder.

The Cayman Islands Court of Appeal (“Court of Appeal”) decision in *Re Strategic Turnaround Master Partnership, Limited* has addressed the issue of how a redemption of shares works and how it affects the rights and liabilities of the shareholder and the company. The Court of Appeal provided clarification of the legal basis of redemptions and when a shareholder ceased to be a shareholder. However, the decision raises some pretty tricky practical questions on redemptions, which shareholders really need to take into account when planning an investment exit strategy.

### **The Court of Appeal Decision on Redemptions**

On 12 December 2008, the Court of Appeal delivered its decision concerning the rights of redeeming shareholders and the nature of the redemption process in *Re Strategic Turnaround Master Partnership, Limited*.

In summary, a shareholder, Culross Global Limited (“Culross”), gave notice of intention to redeem its shares to the fund, Strategic Turnaround Master Partnership, Limited (“Strategic”). The constituent documents of Strategic stated that shareholders had the right to redeem shares by giving notice of redemption at least 60 days before the Redemption Date. After the Redemption Date had passed, but before payment of any redemption proceeds to Culross, the directors of Strategic first passed a resolution to “*suspend all redemptions at this time*” and later passed a second resolution to suspend: (i) the calculation of the NAV of shares; (ii) the redemption or issue of shares; and (iii) all notices of redemption.

Culross, claiming to be a creditor of Strategic, petitioned for the winding up of Strategic on the grounds that Strategic was unable to pay its debts and/or it was just and equitable that Strategic be wound up. Strategic applied to strike out the petition of Culross, stating that Culross had no standing to bring the petition as it was not a creditor of Strategic because, by virtue of the suspension of redemptions, no debt was immediately due to Culross.

The judgment turns to a considerable degree on the wording of the Strategic Articles of Association ("Articles") and Confidential Explanatory Memorandum ("CEM"), which documents defined the relationship between the shareholders and Strategic.

In essence, the Court of Appeal held that the terms of the Articles and CEM meant that the directors of Strategic had the power to suspend the actual payment of redemption proceeds to a redeeming shareholder, even though the relevant redemption date had already passed and the redemption price had been determined.

The Court of Appeal also found that Culross, as a redeeming shareholder, remained a shareholder of Strategic until the process of redemption of shares belonging to it was completed. That meant that Culross' rights remained governed by the Articles and CEM, including the resolutions for suspension of redemptions. However, the Court of Appeal also said that Culross became a creditor of Strategic on the redemption date as well, in the sense that Strategic owed Culross a debt that would be provable in any eventual winding up. However, the effect of the suspension of the payment of redemption proceeds was that Culross only had a future and/or contingent right to payment of the sums due to it from Strategic for the redemption of its shares.

At the time of the decision, prospective and contingent creditors had no standing to petition for the winding up of a company (this position changed on 1 March 2009 with the introduction of amendments to the Cayman Islands Companies Law). As Culross only had a future and/or contingent right to payment by Strategic for its redeemed shares it lacked the standing to petition for the winding up of Strategic on the ground it was unable to pay its debts. The Court of Appeal did, however, hold that Culross had standing (because it was still a shareholder) to petition for a winding up of Strategic on the just and equitable grounds and so, on that basis, Strategic's application to strike out Culross' petition was denied.

Culross' application for leave to appeal the Court of Appeal's decision in the *Strategic Turnaround Master Partnership Limited* case to the Privy Council (the final court of appeal for the Cayman Islands) was refused by the Court of Appeal. It remains to be seen whether Culross will seek, and be given, leave to appeal directly to the Privy Council.

### **Analysis of the Decision**

In reaching its decision on the standing of Culross to petition for the winding-up of Strategic, the Court of Appeal usefully reviewed, re-iterated and clarified various aspects of a company's legal relationship with shareholders. Although some of the legal principles might be regarded as obvious or well-established, the decision also gives rise to some questions on how they will actually work in practice. We address what we consider to be the most significant of these below:

#### **1. How are the rights of the Shareholder and the Company in relation to Share Redemptions determined?**

### Finding

The Court of Appeal found that the Memorandum and Articles of Association of Strategic, the CEM and the subscription agreement entered into by prospective shareholders made up the Strategic's constituent documents, and the contract between subscribing shareholders and Strategic. The rights of Culross flowing from its redemption request, and as affected by the subsequent suspension of redemption resolution passed by the directors of Strategic, were determined by reference to the provisions of the Articles, CEM and subscription agreement.

### Comment

It should not be surprising to anyone that what a company, through its directors, can and cannot do, and the rights and liabilities of its shareholders, will often be determined by looking at its constituent documents. The Court of Appeal's decision in Strategic Turnaround highlights the important point for companies, shareholders and potential shareholders alike, that seemingly minor differences in the articles of association can have important ramifications. Redemptions provisions, in particular, can differ widely between funds and it might make a significant difference to redeeming shareholders' rights if for example the provisions allow suspension of NAV calculations or redemption and subscription requests, but say nothing about the power to suspend payments in respect of redemption requests already lodged.

The other issue to be aware of is that not all offering memoranda are seamlessly consistent with a fund's articles. Where there is a difference between the offering memorandum and the articles, it can make working out the rights of the shareholder more difficult.

## **2. When does Redemption take place?**

### Finding

The Court of Appeal decided that "redemption", which was not defined in the Articles, referred to the entire process of redemption, rather than a single step or event. In the Strategic case, analysis of the Articles made it clear that the process included: (i) the giving by Culross of a notice to redeem to Strategic; (ii) the debt to Culross that arose on the Redemption Date; (iii) valuation of the redemption sum due from Strategic to Culross; (iv) payment of the redemption sum by Strategic; and (v) removal of Culross' name from the Strategic register of shareholders.

### Comment

Again, analysis of the Articles was paramount to establish what was required in order for a redeeming shareholder to cease to be a shareholder. The Court of Appeal decided that the provisions in the Articles relating to redemptions only made practical sense by considering redemption as the formal procedure by which a shareholder, having decided

to recoup its investment by seeking redemption (i.e. the buy-back of its shares by the company), informs the company of its intention to do so, thereby setting in train processes for the determination of the redeemable value of the shares, the date(s) of payment of that amount and ending with the removal of the shareholder from the register of members.

The finding that a shareholder does not cease to be a shareholder until paid for the redeemed shares and removed from the register of members is consistent with the Cayman Islands Companies Law provisions that provide that every person whose name is entered on the register of members is deemed to be a shareholder of the company. In the case of Strategic a redeeming shareholder, whose name still appears in the register, remains a shareholder with the same rights and relationship with the company, as set out in the articles, as any non-redeeming shareholder, until his name is finally removed from the register. The Court of Appeal found support for this view in the Articles by contrasting the provision relating to compulsory redemption, which provided for immediate cessation of the rights of the shareholder, with the provisions on voluntary redemptions, which referred to the rights only being affected after redemption, thereby indicating the affect was different to that which occurred on compulsory redemption.

However, this finding may be problematic where the articles and/or offering memorandum of a company provide (as many do) that 90% of redemption proceeds are to be paid within a relatively short time, such as 60 or 90 days from the redemption date, but the remaining 10% is not to be paid until after publication of annual audited accounts. In such a case, the redeeming shareholder presumably remains a shareholder until he is paid the balance of the redemption proceeds and his name is then removed from the register as a shareholder.

In addition, given the emphasis on the names on the company's register of members being definitive of the status of shareholder, a redeeming shareholder would want to seek to ensure they were removed from the register at the relevant time. As maintaining the share register is usually the responsibility of the administrator, in future there may be more scrutiny of what the administrator has done, and when, with regard to the share register.

### **3. Consequences of remaining a Shareholder pending completion of the Redemption process**

#### Finding

In the case of Culross, its redemption proceeds remained unpaid and the register of shareholders still listed Culross, so the Court of Appeal concluded that Culross was still a shareholder of Strategic even though its redemption request had been accepted and the Redemption Date (upon which day the Culross became a creditor of Strategic) had passed. As Culross remained a shareholder of Strategic, it was still bound by the terms of the Articles and CEM and so resolutions validly passed by the directors affecting the rights of the shareholders applied equally to Culross.

## Comment

As noted already a redeeming shareholder might remain as shareholder for quite some time after the redemption date, if for example payment of all the redemption monies is not due until after the completion of annual audited accounts. The redeeming shareholder may therefore remain subject to the provisions of the articles and so, as in the case of Culross, suspensions of part or all of the redemption process coming into force after the Redemption Date could affect the redeeming shareholder. Also, the shareholder could continue to have status as a shareholder to vote (in so far as permitted by the articles) as well as, according to the Court of Appeal, the right to petition to wind up the company on just and equitable grounds.

The Court of Appeal was not called upon to address what the status might be of a redeeming shareholder whose name had been removed from the register but who had not been paid all the redemption proceeds or a redeeming shareholder who had been paid and whose shares were available for re-issue but whose name remained on the register. However, the deeming provisions in the Cayman Islands Companies Law, that the share register determines who is a shareholder, would arguably be a rebuttable presumption and so, subject to the provisions of the Articles in question in regard to a definition of redemption, it is likely that payment for the redeemed shares and the availability of those shares for re-issue would be the determinative factors of whether the redemption had taken place.

## **4. The Scope of the Directors' Powers to Suspend Redemptions**

### Finding

The Articles of Strategic did not specifically allow suspension of payment of redemption proceeds, but the CEM did have such a provision. The Court of Appeal was of the view that "redemption" encompassed the process from giving notice to redeem through to payment of the redemption proceeds and the removal of the shareholder from the share register. The Court of Appeal came to this view as the Articles specifically incorporated the terms of the CEM concerning redemption, so long as they were not inconsistent with the Articles, and the Court of Appeal considered that the suspension capability was spelt out in more detail in the CEM in a way that was not inconsistent with the Articles. The Court of Appeal said the CEM "*merely explains in detail how the powers in the articles may be used in practice.*"

Since the suspension power exercised by Strategic included a power to suspend payment of redemption proceeds, and those proceeds had not been paid to Culross when the Suspension Resolutions were passed, the exercise of the power was valid. However, the Court of Appeal specifically stated it was not deciding if, as a matter of fact, the power had been properly exercised. Also, the exercise of the power to suspend was not prevented by a provision in the CEM stating that payment of 90% of the redemption price would be made no later than 30 days following the redemption date, as that provision

(whether or not it could be characterized as a promise) was stated to be subject to the power to suspend redemptions.

### Comment

This decision again reiterates the importance of the provisions of the articles and offering memorandum and shows how differences between the articles and offering memorandum may create a situation that would not necessarily be appreciated from reading the articles alone. However, the decision also serves as a warning to the directors of a company seeking to suspend subscriptions and redemptions to be precise in the language used in the resolutions passed, and the notices served, and to ensure they are consistent with the articles and offering memorandum.

## **5. Investor as shareholder and creditor**

### Finding

The Court of Appeal found that Culross became a creditor on the Redemption Date in the amount of the redemption value of its shares, which was yet to be quantified. The Court of Appeal's finding was based, in particular, on the provision in the Articles which expressly provided that *"the price to be paid for shares which are to be redeemed shall be deemed to be a liability of the Company from the close of business on the Redemption Day until the price is paid"*.

The Court of Appeal also noted that, where a fund goes into liquidation, a redeeming investor whose redemption date had passed, but who had not been paid its redemption proceeds, would rank behind unsecured creditors but ahead of investors who had not given notice to redeem prior to the commencement of the winding up. The priority position was also noted to be enshrined in provisions of the Cayman Islands Companies Law that expressly provide that, at the date of the winding up, amounts payable in respect of shares which are, or are liable to be, redeemed, but which have not been redeemed, rank behind all other debts and liabilities of the company, but ahead of the claims of shareholders who had not sought redemption before the commencement of the winding up.

### Comment

The special priority of a redeeming shareholder as creditor will mean that directors will need to consider whether they can allow redemptions at any time a company is in financial difficulty without creating issues that might involve claims ranging from preferences to breach of fiduciary duty.

### **Lessons from Strategic**

We consider that, just as the fundamental rule of real estate is "location, location, location!" the fundamental rule for funds is "drafting, drafting, drafting!"

The Court of Appeal has made it clear that the relationship of shareholders and a company is governed by the articles and any other document which sets out the basis of the shareholders' and company's dealings with each other. If these documents clearly, and consistently, set out when a redeeming shareholder is deemed to cease to be a shareholder and exactly what parts of the subscriptions and redemption process, in what circumstances, the directors can control, it will save a lot of problems.

Any shareholder or potential shareholder of a fund needs to read very carefully the articles, the offering memorandum and the subscription agreement to understand exactly how subscriptions and redemptions work and what rights the shareholder has. It cannot be assumed that all fund documents are drafted alike and if Strategic establishes anything it is a particular company's constituent documents should be read very carefully to determine such crucial aspects of the legal relationship between the company and the shareholder as the redemption process.