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Investment Funds Global UPDATER

Current developments in the global investment funds
legal and regulatory environment

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Introduction

The international tax and regulatory initiatives continue to evolve, but it is difficult at the end of 2009 to accurately predict the scope and nature of the legislation and regulations which will be put into effect in 2010. There are several rival pieces of draft legislation in the U.S. and an almost perpetually changing draft directive in the EU. All that we can say with certainty is that tax and regulation will increase in the major fund management centres. We will return to these themes in 2010 as we continue to monitor developments and report on likely outcomes. For this, our final Global Updater of 2009, we are focusing on trends in legal structuring and challenges to closed-ended funds and reporting on important case law regarding redemption rights and offshore administration of companies.

Trend Report - Investor Rights in Closed-Ended Funds

During the financial crisis there has been much focus on the challenges faced by managers of open-ended funds and the legal models for hedge funds have evolved as a result. Less reported, but equally significant, have been legal developments in closed-ended funds. In the short term, the scarcity of cash shifted the balance of the power at the negotiating table from fund sponsors who, in the case of strong performers, have for some years been able to dictate their terms, in favour of investors. Clear patterns in relation to investor rights in closed-ended funds have emerged in the past 12 - 18 months for funds across industries and classifications - whether real estate, private equity or listed structures, the themes are consistent.

Enforcement of investor rights in existing funds

At all stages of a fund's life we have seen increased willingness of investors to enforce their rights, whether regulatory, statutory, constitutional or contractual, in order to negotiate more favourable positions from funds or their managers. The application of such rights to closed-ended funds has led to changed expectations and a perceptible shift of power between investors and fund managers.

The objectives of investors in a closed-end fund structure vary widely and may include the following:

- Insisting upon improved information flows from funds in terms of reporting and in some cases detailed due diligence of the workings of the fund to be carried out by investors.
- Forcing changes to board composition to remove "promoter-appointed" directors from boards. This may be connected with information gathering strategies as touched on above, or may be a means of enforcing more changes to the structure or even as a means of using the fund structure to conduct claims against service providers.
- Requiring changes to fund objectives where the economic assumptions on which the fund was launched have since changed.
- Changes to the terms of management or other service agreements (e.g. negotiations on management fees).
- Requiring returns of capital where uninvested cash is held.
- Allowing fund restructuring including liquidation or combination of assets held by the fund.

In order to achieve these objectives, investors have not been reticent to use company law mechanisms ranging from removing directors to requisitioning general meetings (whether in expectation that a voting majority can be obtained or simply to publicise and pressure the board to consider specific investor concerns) to exert greater control over their investment. Such traditional investor rights are also being pursued in respect of non-corporate structures, such as by general partners in limited partnership structures, although in practice this will be constrained by the contractual mechanisms that are available.

Following the increasing trend of shareholder activism in the corporate arena, investors in closed-ended funds are now frequently exploring or threatening the use of litigation. Causes of action range from unfair



prejudice claims, injunctions, just and equitable winding up or, if permitted, derivative claims. In certain circumstances following such actions, an investor may become a creditor of the fund and thereby rank in priority to other investors on a winding up of the assets of the fund and so timing of such actions has become paramount.

While some of these trends are familiar from the board/shareholder tensions in traditional corporate activism, a further aspect in respect of fund structures tends to be the four-way dynamic between the investors, the directors, the manager and also the regulator in those jurisdictions, such as Jersey, where closed-ended funds are regulated. While an offshore regulator will commonly start from a perspective of investor protection, in many cases all parties need to maintain a clear line of communication with the regulator in order to reflect the regulator's changing priorities as negotiations and as the tactics used by the different stakeholders in a fund develop.

Changing fund terms

Typical examples of some of the more common terms include:

- Requirement for greater transparency/disclosure. This may include for example establishment of investor advisory committees and overall greater investor consultation and influence on the decisions taken by the fund board, or alternatively the adoption of higher standards of reporting including adoption of industry standard guidelines.
- Inclusion of provisions to call for "rescue" financing when needed for the fund in particular for development assets where timescales for effective harvesting of assets has been increased.
- Enhanced conflict management provisions.
- Greater restrictions on the risks that investors are prepared to permit the Fund to take on, including counterparty risk and levels of debt finance and financial covenants.

- Greater alignment of the interests of fund managers with their investors e.g. through the use of fund manager performance fee arrangements.

Changing Dynamics in Fundraising

Due to a number of economic factors the process of successfully closing a fund has become significantly more complex and has led to extended negotiation of the terms of fund documents.

A number of patterns have developed in order to balance investor demands with the desire of the manager to close funds:

- A greater need to secure "cornerstone" investors in order to demonstrate a momentum to a fundraising process.
- At the same time, where in a more favourable economic environment it was common for funds to be raised on a "blind" basis, i.e. without any specifically identified assets for the fund portfolio, it is increasingly necessary to demonstrate that pipeline assets have already been secured for the fund.
- Drawdowns and documentation to achieve these have become more carefully negotiated in order to provide cash when it is needed for the fund.
- There has also been an increased focus on the use of excusal mechanisms for certain investors and in some cases on combining this with means of reducing commitments, or where not successful, the use by managers of default mechanisms.

One of the challenges in the first half of 2009 for managers was the highly constrained fund raising climate which meant that the actual number of new funds being raised was extremely limited, providing little discernable data on new funds. The second half of 2009 has seen an increased ability to achieve closings and going forward it will be critical for managers raising funds to bear in mind the lessons that have been learned through the crisis in order to achieve fund raising in an environment where investors have become familiar with their increased negotiating power.



New Cayman Case Law - Fund redemptions and suspensions

In the matter of Matador Investments Ltd.

On 27 August 2009 the Honourable Mr. Justice Quin delivered judgment in the Grand Court of the Cayman Islands in *In the Matter of Matador Investments Ltd.* This judgment is of particular interest to the investment funds industry, as it is the first Grand Court decision which considers the Cayman Islands Court of Appeal ruling on fund redemptions and suspensions in *In the Matter of Strategic Turnaround Master Fund Partnership, Limited [2008 CILR 447]*.

For a summary of the important points raised in the Strategic Turnaround decision, see our January 2009 Updater (http://www.ogier.com/publication%20library/Cayman_Updater_January_2009.PDF).

Background

The facts in Matador are very similar to those in Strategic Turnaround: two shareholders submitted requests to redeem the entirety of their respective shareholdings in Matador Investments Ltd (the "Fund"), an exempted Cayman Islands company operating as a private investment fund, with an effective redemption date of 30 June 2008. The Fund's private placement memorandum provided that redemption proceeds were to be paid to redeeming investors within 30 days of a redemption date. On 27 June 2008, however, the Fund's directors resolved to impose a 10% gate on redemptions on 30 June 2008, so that only 10% of the shareholders' redemption proceeds were payable on that date. The Fund duly part-paid each shareholder's redemption proceeds on 4 August 2008 (the Fund in fact 'waived the gate in part' and paid the shareholders almost 20% of their redemption proceeds).

The directors of the Fund subsequently resolved, on 12 March 2009, to 'suspend calculations of net asset value ("NAV"), subscription and redemption rights because the Fund was facing a liquidity crisis and was unable to provide money to satisfy the redemption requests made'. The directors' resolution provided

that 'this suspension is inclusive of the redemption requests received for the 31st December 2008 redemption date (including those brought forward from previous redemption days that had been gated)'.

Petition

In May 2009, the shareholders jointly petitioned the Grand Court for the winding up of the Fund on the grounds that it was clearly insolvent and was unable to pay its debts. In response, the Fund argued inter alia, that the Court should not order its winding up as the gate on redemptions was validly imposed and as redemptions were subsequently suspended, the shareholders lacked locus standi.

The Fund submitted that because of the suspension of redemptions on 12 March 2009, there was no present obligation on the Fund to redeem any shares, which in turn meant that no sums were presently due and owing to any shareholder. The Fund sought to rely on Strategic Turnaround and argued that because the petitioning shareholders' shares were only partially redeemed, those shareholders remained bound by the Fund's Articles of Association and were therefore bound by the 12 March 2009 resolution to suspend redemptions.

The relevant provisions of the Fund's Articles of Association's were Article 5(j), which provided that 'no redeemable shares of a particular class shall be redeemed whilst the calculation of the net asset value of that class is suspended', and Article 14, which provided that 'the directors may in their absolute discretion suspend the determination of the net asset value of any relevant class and consequently the subscription and rights of redemption of the redeemable shares of the class hereunder in the following circumstances if in the opinion of the board of directors such circumstances are prejudicial to the members of that class or the company...'.

The Fund accepted that, in accordance with Strategic Turnaround, the shareholders became creditors of the Fund on the relevant redemption date (30 June 2008), but it submitted that in light of the Court of Appeal's finding in Strategic Turnaround that 'redemption' was



a process, beginning with the submission of the redemption request and ending with the payment in full of the redemption price, the references to 'redemption' in Articles 5(j) and 14 'must be referring to the entire process of redemption'. The Fund made this submission because its Articles and PPM (unlike the PPM in Strategic Turnaround) did not contain any express entitlement to 'suspend the payment of redemption proceeds'. However this is inconsistent with Strategic Turnaround, because 'redemption' includes payment.

It seems, however, that no submissions were made to the Court based on the fact that both of the aforementioned provisions of the Fund's Articles of Association refer to the suspension of the calculation (or determination) of the Fund's NAV, and that Article 14 refers to the consequent suspension of subscription and redemption rights. In this case, it appears that the relevant NAVs for 30 June 2008 were in fact calculated and published, and it accordingly seems that no suspension of redemptions for the 30 June 2008 redemption date could properly have been made in March 2009 in any event.

Decision

The Grand Court found that the facts in this case were different from those in Strategic Turnaround and held that because the Fund's Articles and PPM only referred to the 'suspension of redemption' and not to any suspension of the 'right to receive redemption proceeds', the power to suspend redemptions only applied to 'redemptions which have not been made and cannot apply to redemption requests that have already been validly made and on which payment is due'. In his ruling, Quin, J. stated that, 'Strategic Turnaround is not authority for the proposition that a Fund may impose a suspension on an investor's right to receive redemption proceeds at any time' and that 'there is no authority of which this Court is aware, that a Fund, in the absence of an express power may purport to institute a retrospective suspension of payment of redemption proceeds'.

Accordingly, Quin, J. held that a fund 'cannot suspend a debt due and payable... where there is no specific

power in the Articles, or the PPM, to do so' and he accordingly ordered that the Fund be wound up as it was unable to pay its debts.

Comment

Whilst the Matador decision clearly highlights that cases involving redemption disputes will be determined on the construction of the particular contractual documents in each case, the narrow interpretation of 'suspension of redemption' applied by Quin J. in this case does not appear to be entirely consistent with the 'process of redemption' formulated in Strategic Turnaround, which suggests that if 'redemption' may be suspended, this includes a right to suspend payment of redemption proceeds, because 'redemption' is a process of which payment is an integral part.

We understand that the Matador decision is subject to an appeal, and we await the Court of Appeal's views with interest.

Ogier suggests actions

As noted in our report on Strategic Turnaround, clear explicit provisions are required in a fund's offering documents and articles of association if it wishes to have the ability to suspend redemption payments. We continue to advise that regardless of whether or not a fund wishes to have such a power at its disposal, it is important that the fund's contractual documents expressly provide that a redeemed member ceases to have all the rights of a shareholder and that its name be removed from the register of members on the relevant redemption day. In this way, all parties will have certainty as to their rights post the relevant redemption date.

Management and Control - lessons for administrators

Introduction

The implications of *Wood v Holden* in 2006 have manifested themselves in the daily operations of fund administrators. In that case, which was a ruling by



the English Court of Appeal on the tax residency of an offshore corporation, it was determined that for a company to be considered non-UK resident, it had to abide by the following requirements: the majority of directors to be non-UK resident; all directors' meetings to be held abroad; and directors' meetings to be held and properly minuted.

More recently, *Laerstate BV v HMRC* concerned an appeal by a Dutch company, Laerstate BV against an assessment of corporation tax for gains made on its disposal of shares in Lonrho plc.

The decision that Laerstate was deemed UK resident on a review of detailed evidence sends a clear message to shareholders, directors and administrators of offshore companies who wish to avoid falling within the UK tax net, that that "mind and management" of a company's activities must be demonstrably conducted offshore.

Laerstate was established in the Netherlands to hold shares in Lonrho plc for its beneficial owner, Dieter Bock. Laerstate was charged corporation tax in the United Kingdom on gains arising on its disposal of shares in Lonrho on the basis that Laerstate was resident in the United Kingdom for tax purposes at the time the gains were paid. Laerstate appealed the assessment, claiming that it was not UK resident either when it acquired or when it disposed of its shares in Lonrho.

HMRC produced detailed evidence that, in certain circumstances, contradicted the record maintained in Laerstate's minute book and that ultimately demonstrated that central management and control was exercised by Bock even after he had resigned as a director. Bock's decisions effectively usurped the powers of the overseas board, which had not generally received or considered information which would have enabled it to make any reasoned evaluation of the background to its recorded decisions.

HMRC used its investigative powers under the Finance Act 2008 to gather evidence that demonstrated that key executive decisions were made not by the offshore directors, but by Bock himself, as he

had remained intimately involved with policy and strategic matters in the operation of the company. Offshore administrators need to be aware of their role in the fulfilling of the burden of proof of the taxpayer. The HMRC will be looking for more substantial documentation than the humble minute book, and therefore the retention of agendas, flight schedules and diary entries could be crucial in demonstrating that management and control is exercised offshore and ought to be considered when addressing operational procedures. Administrators may need to demonstrate not only that the offshore board uses its commercial judgement and acts conscientiously, but also that the board's powers are not usurped by strategic decision-makers based in the UK.

The Laerstate ruling highlights the need for the board of directors of an offshore company to be provided with sufficient information within a sufficient timeframe to make informed decisions. A short shopping list of best practices for administrators include: ensuring investment proposals and recommendations are sent to the board in accordance with the vendor's timetable; the retention of email traffic records to illustrate how much time directors were given to consider discussion documents prior to meetings; board minutes should reflect what documentation was tabled and that such documentation was properly considered; powers of attorney should be used only when absolutely necessary and any action points arising from meetings must be followed up and documented. This will comprise the body of evidence (that can be produced years later if necessary) that demonstrates that real decision making power rests with the offshore board.

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