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Weavering in the Cayman Islands

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The Privy Council's recent judgment in *Weavering*[1] upheld the decisions of the Cayman Islands Grand Court and Court of Appeal that payments made to redeemed investors immediately prior to the fund's liquidation were preference payments under section 145(1) of the Companies Law (2018 Revision) (**Law**), and must be repaid.

The decision clarifies that the principle established in *Fairfield*[2], that a net asset value (NAV) determined in accordance with the fund's articles is binding on all parties and cannot be undone, does not apply where the NAV has been impacted by a fraud perpetrated *by* (rather than *against*) the fund. In doing so, the Privy Council has opened the door for NAVs for fraud-impacted investment funds to be unwound, but just how far remains to be seen.

The judgment is a cautionary tale to custodians and nominees who receive redemption monies in that capacity and pay them out to their underlying clients without the necessary indemnities in place.

Background

Skandinaviska Enskilda Banken AB (SEB) was the registered owner of shares in Weavering Macro Fixed Income Fund (Weavering), a Cayman Islands investment fund. SEB held those shares as custodian and nominee on behalf of its clients, two mutual funds.

In October 2008, SEB submitted redemption requests for all of the shares it held as custodian and nominee. SEB received its redemption moneys (SEB Redemption Payments) from Weavering, but other investors who had also submitted redemption requests prior to the liquidation, did not.

In March 2009, Weavering went into liquidation in the Cayman Islands following the discovery that its investment manager and controlling mind, Magnus Peterson (Peterson), had been concealing heavy losses with fictitious interest rate swaps, thereby fraudulently inflating Weavering's NAV.

Weavering's liquidators issued proceedings against SEB in August 2014, seeking a declaration that the SEB Redemption Payments were invalid as voidable preferences under section 145(1) of the law, which states:

'*Every conveyance or transfer of property…made…by any company in favour of any creditor at a time when the company is unable to pay its debts within the meaning of section 93 with a view to giving such creditor a preference over the other creditors shall be invalid if made…,within six months immediately preceding the commencement of a liquidation.*'

Both the Grand Court and the Cayman Islands Court of Appeal held that the SEB Redemption Payments were invalid preference payments under s.145(1), and ordered SEB to repay the amounts. The Privy Council unanimously upheld the Court of Appeal's ruling, although for slightly different reasons.

Only internal fraud can undo a binding NAV

One way for SEB to defeat the preference claims was to establish that Weavering was solvent at the time it made the SEB Redemption Payments. SEB argued that the published NAVs were not binding pursuant to Weavering's articles of association because they had been inflated by Peterson's fraud. On this basis, SEB (and Weavering's other redeemers) had not become redemption creditors, Weavering would not have been insolvent at the time it made the SEB Redemption Payments, and s.145(1) would not apply.

Both the Grand Court and the Court of Appeal held that Weavering's NAV was binding. Both Courts primarily relied on the Privy Council's 2014 decision in *Fairfield* which held that NAVs determined in accordance with a fund's articles of association are binding irrespective of fraud, and could not be revisited. However, a majority[3] of the Privy Council distinguished *Fairfield* on the basis that the fraud in Weavering fraud was '*internal*' (i.e. the fraud was perpetrated *by* Weavering, through Peterson as its controlling mind) whereas the fraud in *Fairfield* was '*external*' (i.e. the fraud was perpetrated '*on*' the company and the directors had published the NAVs in good faith).

While the Privy Council held that Peterson's internal fraud was capable of unravelling the NAV, it also held that such unravelling was not automatic. Rather, the NAV remained binding until someone who had suffered loss as a result of the fraudulent NAV successfully sued to have the NAV avoided for fraud. In this case, SEB had not suffered any loss but had rather received payments substantially higher than it would have had the redemption payments been calculated by reference to a honest and accurate NAV.

The intention to prefer point

It is settled law that the requirement in s.145(1) for a payment to be made '*with a view*' to preferring a creditor requires a '*dominant intention to prefer*'. The application of this test is highly fact-specific. The Privy Council upheld the Court of Appeal's decision that it could be inferred that Weavering (through Peterson) had the dominant intention to prefer SEB based on the facts of this case.

SEB had, without agitating for payments, received redemption moneys in preference to other similarly situated redemption creditors, and there was significant documentary and oral evidence at trial that Weavering had intended to prefer SEB. The Privy Counsel rejected SEB's argument that the Liquidators were required to establish commercial impropriety.

The Privy Council, like the courts below, found it unnecessary to decide whether the dominant intention to prefer could be inferred simply from the fact that the company was aware it was insolvent at the time payment was made. Such a finding would have made it significantly easier for Cayman Islands liquidators to bring successful preference claims under s.145(1).

Repayment issues

SEB had already paid the SEB Redemption Payments to its underlying clients and it had no contractual entitlement to recover those moneys from its clients. SEB argued that it was entitled to rely upon the common law defences to restitutionary claims, including that SEB had not in fact been enriched by the payments and that it had changed its position

by paying the moneys away. The Grand Court and Court of Appeal held that the common law defences did not apply. The Privy Council disagreed, but found that the defences were not available to SEB.

The Privy Council held that payments captured by s.145 were voidable and, because the provision was silent as to the consequences, the common law must apply. The Privy Council held that SEB had been enriched because it was the registered and legal owner of the shares, and therefore legally entitled to the SEB Redemption Moneys. It did not matter that SEB's underlying clients held the beneficial ownership in the moneys.

The Privy Council also rejected SEB's change of position defence. It held that the common law gives priority to the statutory scheme of *pari passu* distribution and should not, as a matter of public policy, be used to undermine that distribution scheme by effectively allowing a creditor to retain moneys that were received in preference to other creditors[4].

The Privy Council acknowledged that the unavailability of the change of position defence may lead to '*harsh results'* for bona fide transferees. The Pricy Council noted that such difficulties had been addressed by legislation in England & Wales and other jurisdictions[5] but that the issue was ultimately a matter for the Cayman Islands legislature.

Discussion

In a series of cases prior to *Weavering*, the Privy Council emphasised the importance of certainty for investors and the investment fund industry.

In *Strategic Turnaround*[6], *Fairfield* and *Herald*[7], the Privy Council handed down rulings which acknowledged that the proper operation of investment funds relied upon innocent investors having certainty that once they had validly redeemed out of the funds, they were entitled to rely upon their creditor status and the NAV which had been struck.

In finding that NAVs impacted by fraud may be unwound following successful legal proceedings, *Weavering* arguably erodes this general guiding principle of investor certainty. The point was made in Sir Donnell Deeny's separate opinion (with which Lord Wilson agreed), that the retrospective alteration of a NAV would tend to render the operation of an investment fund '*unworkable'*.

Just how fair the principle of investor certainty has been eroded as a result of this decision remains to be seen. The creation of different rules for internal and external frauds may give rise to difficult factual questions as to how to distinguish between the two types of frauds. For example:

1. it is not clear how '*internal*' a fraud must be to give rise to a right to have the NAV unwound. For example, what if a majority of members or the board of directors were acting in good faith in respect of the determination of the NAV?
2. it is not clear how much of a quantitative impact the fraud must have on the NAV to justify unravelling and restating the NAV. What if the underlying fraud impacted just five per cent of the fund's NAV? What if that figure was 49, or 51 per cent?

The majority of the Privy Council acknowledged these difficulties, but were not required to grapple with them, given Peterson's control of Weavering, and the size and pervasive nature of the fraud.

Another area of uncertainty is who may have standing to bring the action to avoid NAVs, what the cause of action would be, and who would be the defendant. It may be that when these various areas of uncertainty are resolved, the scope for NAVs to be unwound is minimal.

Weavering is not the last we will hear from the Privy Council on NAVs of Cayman Islands investment funds. A further trial connected to the ongoing Herald liquidation is currently scheduled to take place in the last quarter of this year. In that case, the Privy Council will be asked to determine the circumstances in which a liquidator can unravel a NAV and rectify the share register of a solvent fund. However, that case involves an "external" fraud (the Madoff fraud) and it is therefore unlikely that the Privy Council will be required to consider the questions posed by its decision in *Weavering*.

[1] *Skandinaviska Enskilda Banken AB v Conway & Anor* [2019] UKPC 36

[2] *Fairfield Sentry Ltd v Migani* [2014] UKPC 9 [2014] UKPC 9

[3] A separate opinion by Sir Donnell Deeny (with whom Lord Wilson agreed), held that a NAV could not be voided, irrespective of whether it was impacted by an internal or external fraud. Nevertheless, Sir Deeny came to the same conclusions as the majority of the Board, that (i) proceedings may be brought by a party which has suffered loss to have the NAV in a transaction based upon it avoided for fraud; and (ii) the conclusion that the NAV is voidable for fraud would not assist SEB in any event, as SEB had not been defrauded.

[4] In their separate opinion, Sir Deeny and Lord Wilson agreed that the change of position defence should not apply, and held that SEB's loss was not due to a change of position, but rather its failure to put in place enforceable indemnities with its clients.

[5] In England and Wales, sections 241(2) and 425(2) of the Insolvency Act 1986 provide a bona fide purchaser defence in order to protect third parties dealing with the person who obtained property from the company. In New Zealand, section 296 of the Companies Act 1993 provides bona fide purchaser and change of position defences to protect third parties and transferees, respectively.

[6] *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited* [2010] UKPC 33

[7] *Pearson v Primeo Fund* [2017] UKPC 19

COLLAS CRILL

For more information please contact:

Rocco Cecere

Partner | Cayman

t: +1 345 914 9630 | **e:** rocco.cecere@collascrill.com