BERMUDA

AN ASSESSMENT OF BERMUDA'S LEGAL SYSTEM HANDLING HEDGE FUNDS IN DISTRESS

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INTRODUCTION

Hedge funds incorporated in Bermuda, as well as their directors, managers, service providers, creditors and investors, faced substantial legal challenges as a result of the global financial crisis from 2008 onwards. Now that the dust has started to settle on the first wave of litigation, this article seeks to look back over the past 5 years, with a view to assessing how well the Bermuda legal system resolved those legal challenges, especially in comparison with the legal systems of competitor jurisdictions, such as the Cayman Islands and the British Virgin Islands. In what areas did Bermuda's legal system do well, and in what areas did the system fall short? Where might there be room for Bermuda to improve in the future?

ISSUES FACED BY BERMUDA'S FUNDS INDUSTRY FROM 2008 ONWARDS

The financial crisis created several legal impacts on Bermuda funds:

Investment Losses. Some hedge funds suffered investment portfolio losses and devaluation of their assets. Losses occurred through bad luck, innocent mistakes, negligence, and, in some cases, acts of dishonesty or fraud. Various Bermuda hedge funds were adversely affected by the sub-prime mortgage crisis in the US, as well as the global credit crunch more generally. In addition, a number of Bermuda hedge funds were badly affected by Ponzi scheme frauds such as those perpetrated by Bernard Madoff and Thomas Petters.

Leverage Problems. Many hedge funds used leverage to pursue their investment strategies. Many hedge funds found it difficult to borrow money as easily or as cheaply as before. Various hedge funds defaulted on their borrowing obligations, and were unable to satisfy contractual obligations owed to counterparties. Hedge funds were increasingly exposed to margin calls by lenders or brokers. In some cases, hedge funds found themselves in breach of investment restrictions relating to leverage.

Illiquidity. Many assets held by hedge funds became (and to some extent remain) illiquid. Hedge funds found themselves unable to liquidate investments within a reasonable period of time or for a reasonable price. There were various reasons for this loss of liquidity. In some cases, the relevant market contracted or collapsed. In other cases, assets were frozen as a result of the difficulties of various banks, insurers, prime brokers, custodians, and other funds or companies in which, or through which, various hedge funds were invested, including Lehman Brothers, Bear Stearns, Merrill Lynch, AIG, and entities related to Bernard Madoff and Thomas Petters.

Valuation Errors and Delays. Many hedge funds found themselves unable to value their investments accurately or within a reasonable period of time. This resulted in delayed or inaccurate calculation and publication of Net Asset Value (NAV) statements to investors, as well as delayed, inaccurate, or qualified accounts, statutory returns, and audited financial statements. Delays or inaccuracies were attributable, variously, to innocent mistakes, negligence, and, occasionally, dishonesty or fraud. Errors in NAV statements occasionally resulted in overpayments or underpayments, or inaccurate share subscriptions and redemptions. Errors also resulted in overpayments or underpayments to fund managers and service providers, whose fees were calculated by reference to a hedge fund's NAV.

Loss of Capital and Rush of Redemption Requests. Many hedge funds found it difficult to raise new capital through new share subscriptions. At the same time, many hedge funds faced an increased number of redemption requests from shareholders seeking to leave the fund at a time when they did not have enough cash or liquid assets to pay all of them at the same time. There were a variety of defensive strategies potentially available to hedge funds holding illiquid assets when faced with a rush of redemption requests, and requests for payment of redemption proceeds. The availability or suitability of any of these strategies (with or without investor consent) depended on the terms of each hedge fund's constitutional documents, and the facts and commercial considerations of each particular case. Such strategies included:

- Reliance on a 'lock-up' or 'lock-in' period. Some hedge funds were structured so that redemptions were subject to an initial lock-up for the first few years following subscription. Some funds allowed for redemption during lock-ups subject to an early redemption charge.
- The alteration of provisions as to redemption notice periods, redemption dates, or their frequency.
- The suspension of determination of the hedge fund's NAV, along with a suspension of subscriptions and redemptions.
- The suspension of the date for payment of the redemption proceeds.
- The imposition of a 'gate' on redemptions. The purpose of a 'gate' was to restrict the level of redemptions that an investor could demand on any particular redemption date. Gates were frequently set at between 10% and 20% of NAV. Where redemption requests exceeded the 'gate' maximum, shares were redeemed in priority to subsequent redemption requests, or on a pro rata basis with the remainder held over to the next redemption date (until 'gated' redemption requests were satisfied in full).
- The creation of a 'side pocket' or a special purpose vehicle ('a synthetic side pocket') for illiquid investments. This is where a hedge fund segregated illiquid assets from the main fund, and investors ended up with two holdings, one in the main fund and one in the side-pocket. Under the 'synthetic side pocket' strategy (the legality of which was always debatable, and has been significantly undermined by a number of recent Court decisions), the hedge fund created a special purpose vehicle ('SPV') to which it conveyed the hedge fund's illiquid assets in return for shares or security interests. It then transferred those shares or security interests to its redeeming investors as payment 'in kind' of the redemption price that was owed to those investors.
- The compulsory redemption of investors' shares.
- The payment of redemption proceeds 'in kind' (often deployed as part of the 'synthetic side pocket' strategy').
- The restructuring of the hedge fund, whether by way of a formal Scheme of Arrangement subject to the sanction of the Court, or by way of an out-of-court restructuring requiring either unanimous consent or super-majority consent (depending on the terms of the fund's documents).
- The conversion of the hedge fund from an open-ended to a closed-ended fund.
- The voluntary or compulsory liquidation of the hedge fund.

The problem with all of these strategies was that there was rarely a common interest, or consensus, between the hedge fund's directors and managers on the one hand, and the hedge fund's investors and creditors on the other. There was also significant disagreement between a hedge fund's redeeming investors (who wanted to leave the fund) and its non-redeeming investors (who wanted to remain in the fund). The scope for dispute was enhanced by the fact that many hedge funds' constitutional documents were silent on these issues, or were unclear, ambiguous, or inconsistent at best.

RAISED DISPUTES IN BERMUDA

Against this background, there were, broadly speaking, three main kinds of hedge fund disputes that arose in Bermuda as a result of the global financial crisis, in common with other offshore jurisdictions such as the Cayman Islands and the British Virgin Islands.

(1) Claims by investors against hedge funds

Firstly, there were claims by investors against hedge funds. These claims came in a wide variety of forms, depending on the facts and circumstances. They included:

- Investor claims for rescission of the contract of allotment of shares or repayment of the subscription price, on grounds of misrepresentation, mistake, or failure of consideration.
- Investor claims for payment of a debt or damages, on grounds that a redemption request, or a compulsory redemption, has not been satisfied.
- Investor claims for damages for loss of profits, on grounds of misrepresentation, breach of contract (for example, breach of the fund's investment restrictions), negligence, breach of fiduciary duty, dishonesty or fraud.
- Investor claims for proprietary or equitable remedies, if, for example, the investors could establish that their investments are held by the hedge fund on trust.
- Investor claims for specific performance, injunctions, or declarations as to their rights and the hedge fund's obligations.
- Investors' petitions to wind up hedge

funds, either on grounds of insolvency, or on just and equitable grounds (if, for example, the hedge fund's commercial purpose had been frustrated, or there is unfair prejudice or oppression of minority shareholders), as well as applications to appoint liquidators nominated by the investors.

These claims required close analysis of the terms of the hedge fund's constitutional and contractual documents, as well as relevant principles of contract law, company law, and common law (and, in the case of a limited partnership, partnership law). Occasionally, hedge fund investors sought to pursue direct claims for damages or other remedies against hedge fund directors or service providers. In the absence of a direct contractual relationship between the investors and the hedge fund's service providers, or in the absence of a clear assumption of direct responsibility or fraudulent conduct, however such claims were difficult to pursue as a matter of Bermuda law (and were more often asserted in the US courts).

Some reported examples of these kinds of claims in Bermuda include:

- *Re Stewardship Credit Arbitrage Fund Ltd* [2008] Bda LR 67.
- *Kingate Global Fund Ltd v Knightsbridge USD Fund Ltd* [2009] Bda LR 59.
- *UBS Fund Services (Cayman) Ltd and Tensor Endowment Ltd v New Stream Capital Fund Ltd* [2009] Bda LR 74, [2010] Bda LR 38, [2010] Bda LR 64.
- *BNY AIS Nominees Ltd v New Stream Capital Fund Ltd* [2010] Bda LR 34.
- *Re A Company* [2010] Bda LR 77.
- *Xena Investments Ltd v New Stream Capital Fund Ltd* [2011] Bda LR 4.
- *Alpha Prime Fund Ltd v Primeo Fund Ltd* [2011] Bda LR 51.

(2) Claims by hedge funds against directors, officers and service providers

Secondly, there were claims by hedge funds against their directors, officers, and various agents or service providers, including their investment managers, investment advisors, auditors, administrators, attorneys, NAV calculation agents, custodians, corporate service providers, and prime brokers. These claims have, for the most part, been asserted and pursued by the liquidators of hedge funds, as part of the asset recovery exercise after a hedge fund's liquidation, normally on grounds of insolvency. Again, these claims have come in a wide variety of forms, depending on the facts and circumstances. They have included:

- Hedge fund claims against directors and officers for damages or compensation for breach of their fiduciary duties, breach of contract, breach of their statutory obligations, negligence, and dishonesty or fraud;
- Hedge fund claims against investment managers for damages for breach of their fiduciary duties, breach of contract, negligence, and dishonesty or fraud;
- Hedge fund claims against investment managers for restitution, seeking to clawback mistaken overpayments made in respect of their management or performance fees;
- Hedge fund claims against administrators, auditors, custodians, prime brokers, and attorneys for breach of contract, breach of their statutory obligations, and negligence;
- Hedge fund claims against investment managers, administrators, NAV calculation agents, and auditors, for errors and omissions in the valuation of their assets, the calculation of NAV statements, and the detection and reporting of financial irregularities or breaches of investment restrictions;
- Hedge fund claims for proprietary or equitable remedies, if they could establish that assets are held by custodians or prime brokers on trust for them.

Some reported examples of these kinds of claims being pursued in the hedge fund context in Bermuda include:

- *Phoenix Global Fund Ltd and Phoenix Capital Reserve Fund Ltd v Citigroup Fund Services (Bermuda) Ltd & The Bank of Bermuda Ltd* [2007] Bda LR 61, [2009] Bda LR 68, [2009] Bda LR 70.
- *Kingate Global Fund Ltd v Knightsbridge USD Fund Ltd* [2009] Bda LR 59.
- *Kingate Global Fund Ltd & Kingate Euro Fund Ltd v PricewaterhouseCoopers* [2010] Bda LR 55, [2011] Bda LR 41.
- *Re Kingate Management Ltd* [2012] Bda LR 14, [2012] Bda LR 63.

(3) Claims in liquidations

Thirdly, there were claims or contentious applications that arose in the liquidation context (including in the context of cross-border multi-jurisdictional liquidations, internationalism being a common feature in most offshore hedge fund structures). These have taken a variety of forms, depending on the circumstances and stage of the liquidation.

For example, there have been disputes as to whether or not a hedge fund should be put into liquidation, and, if so, when and under whose control.

There have also been disputes about the recovery of the fund's documents and assets, including improper payments made prior to liquidation, such as fraudulent preferences, as well as disputes about the timing and method of liquidation and distribution of the fund's assets, as well as the proof and priority of payments to the various interested parties, including creditors and shareholders. There have also been a number of cases that have considered 'segregation' issues arising under Bermuda's Segregated Accounts Companies Act 2000, and upheld the integrity of those legislative provisions.

Some reported examples of these kinds of claims being pursued in the hedge fund context in Bermuda include, in addition to those already mentioned above:

- *Re Kingate Global Fund Ltd & Re Kingate Euro Fund Ltd* [2010] Bda LR 57.
- *Re Kingate Global Fund Ltd (in Liquidation)* [2011] Bda LR 2.
- *Re Founding Partners Global Fund Ltd (in Liquidation)* [2011] Bda LR 22.
- *Re CAI Master Allocation Fund Ltd* [2011] Bda LR 57.

HOW DID BERMUDA'S LEGAL ENVIRONMENT FOR HEDGE FUNDS SURVIVE THE STRESS TEST?

Although views may differ, this author believes that Bermuda's legal environment has stood up very well, by comparison with competitor jurisdictions such as the Cayman Islands and the British Virgin Islands.

Firstly, it is this author's view that Bermuda's Commercial Court judges have, for the most part, come up with good, commercial results at first instance. Support for this proposition can be found in the fact that very few of the hedge fund decisions published by Bermuda's Commercial Court over the past five years have been the subject of any further appeals to the Court of Appeal or the Privy Council. The BVI and Cayman commercial courts, by contrast, have seen a large number of their decisions appealed to their respective Courts of Appeal, and even the Privy Council, often successfully.

Secondly, whatever the winner or loser might have thought of the first instance judgments themselves, there can be no doubt that Bermuda's Commercial Court judges have been extremely quick to hold their hearings, and then to publish their reasoned judgments, with the assistance of a user-friendly and efficient Court Registry. This has led to all dispute parties being able to achieve commercial certainty sooner rather than later.

In contrast, the BVI and Cayman Courts have not only taken longer to publish judgments at first instance, but the fact that there have been so many appeals has resulted in very considerable delay in the resolution of hedge fund disputes.

This is an achievement of which Bermuda can be proud, and which should, all other things being equal, attract more funds to Bermuda. Fund managers, fund directors, fund service providers and fund investors should all be comforted that Bermuda's court system will enable them to have any disputes resolved quickly, efficiently, and in all likelihood, correctly at first instance.

Another competitive advantage that Bermuda has had during the course of the financial crisis is that those Bermuda fund structures that have made use of Bermuda fund service providers (managers, auditors, administrators, custodians, etc) have had a stronger case, when put into liquidation by a Bermuda court, for securing Chapter 15 recognition by a US court under the US Bankruptcy Code, on the basis that Bermuda is clearly the fund's Centre of Main Interests. This has enabled Bermuda fund liquidators to move quickly in securing documents and assets, and ultimately returning dividends to creditors and investors. This ready Chapter 15 recognition of Bermuda liquidators can be contrasted with some of the Cayman funds that were denied Chapter 15 recognition since they had no real nexus with Cayman other than some local Caymanian directors. Although fund promoters may prefer to have the flexibility of using service providers in many different jurisdictions, and there may no longer be the same tax considerations as there used to be in off-shoring all of their services, they (and their investors) should still understand the benefits of having one particular offshore centre as the fund's [Centre of Main Interests] (in the event of a liquidation).

This is not to say that Bermuda can afford to be complacent. There are plainly a number of areas of Bermuda law which could be improved and updated, particularly in the area of restructuring and insolvency legislation. Although this can be a dry topic, it would plainly be beneficial if legislation could be enacted to facilitate international co-operation in insolvency matters, and if further thought could be given to a more efficient restructuring tool for Bermuda funds than a Scheme of Arrangement, whether initiated before or after the commencement of a liquidation. However, in this respect, Bermuda's current legislation is no worse than its competitor jurisdictions, and at least Bermuda has the benefit of having Commercial Court judges that are willing to fashion pragmatic commercial solutions to problems that have not yet been fully addressed by legislation.