

BRITISH VIRGIN ISLANDS NEW MUTUAL FUND CASE *WESTERN UNION INTERNATIONAL LIMITED vs. RESERVE INTERNATIONAL LIQUIDITY FUND LTD.*

Robert Briant & Anton Goldstein – February 2010

The British Virgin Islands Commercial Court has recently delivered a decision in *Western Union International Limited vs. Reserve International Liquidity Fund Ltd.* which will be of interest to all fund managers and practitioners. In particular, the case considers (i) the redemption process and the point in time at which a redeeming shareholder becomes a creditor and ceases to be a shareholder of a fund; and (ii) the appointment of a BVI liquidator to a fund which is already subject to liquidation proceedings in another jurisdiction.

Background Facts

The Reserve Fund was a BVI incorporated mutual fund which, in common with other money market funds, aimed to invest in high-quality, short-term debt and maintain a stable net asset value (NAV) of US\$1 per share. However, for only the second time in history, the Fund “broke the buck” when its NAV fell below US\$1 per share as a result of the bankruptcy of Lehman Brothers.

Western Union had submitted a redemption request to redeem its 298 million shares in the Fund on the same day Lehman Brothers filed for bankruptcy - September 15, 2008 - when NAV was still being calculated by the Fund at US\$1 per share. However, with effect from September 16, the Fund suspended its calculation of net asset value and the redemption of its shares.¹ Western Union subsequently claimed it was a creditor of the Fund for the full amount of \$298m and applied to appoint a liquidator.

The Fund resisted the application on the basis that Western Union was not a creditor and that proceedings to distribute the remaining assets of the Fund (cash in a bank account in Boston) were already ongoing in the United States. The BVI Financial Services Commission (“FSC”) and certain other investors in the Fund also appeared to support the Fund. In particular, it was argued that the US proceedings, which evidence suggested would result in a *pro rata* distribution between all investors in the Fund irrespective of whether or not they had been redeemed, presented a preferable alternative to liquidation and should be allowed to proceed without interference from a BVI liquidator.

In this regard, the Court noted that distributing the remaining assets of the Fund *pro rata* would likely result in investors receiving 95 cents in each dollar. However, recognising as creditors those investors who had redeemed when the NAV was still calculated at US\$1 would leave virtually nothing for the shareholders who had not submitted redemption requests on September 15, 2008.

Summary of Decision

The key conclusions of the BVI Court, which are each examined in more detail below, were that:

1. Western Union was a creditor of the Fund for the full amount of \$298m. As such, it was entitled to receive payment of its redemption proceeds in priority to all non-redeemed shareholders.
2. The redemption proceeds due to Western Union were not owed to in its capacity as a shareholder because the redemption process was completed on the dealing day. As such, section 197 of the Insolvency Act – which subordinates certain debts owed to shareholders to debts owed to other unsecured creditors – did not apply. Western Union would therefore be entitled to prove in liquidation equally with any other unsecured creditors of the Fund.

¹ Although there were some inconsequential evidential discrepancies in this regard.

3. The right of a shareholder or creditor of a BVI company to have a liquidator appointed in the BVI will not be defeated simply because there are foreign proceedings that may offer an alternative remedy. This was (a) particularly the case as the US proceedings would result in a *pro rata* distribution and therefore would not respect the rights of redeemed shareholders (as creditors) to be paid out in priority to other shareholders; and (b) despite the fact that a BVI liquidator was unlikely to be able to obtain control of the Fund's remaining assets in the United States because of the difficulties it would have in obtaining Chapter 15 recognition.

Creditor vs. Shareholder

The Fund argued that Western Union was not a creditor because, although it had submitted a redemption request on a dealing day when the NAV was calculated at US\$1 per share, the redemption process was still not complete. In particular, the Fund pointed to a provision in its articles of association stating that "requests for redemption on a dealing day will generally be honoured within seven days of receipt" and also noted that the redemption proceeds had not yet been paid.

The BVI Court rejected these submissions and held the redemption was complete on the September 15 dealing day at a redemption price of US\$1 per share. Accordingly, it was held that Western Union was a creditor of the Fund for the full amount of \$298m. While the reasoning in this aspect of the judgment is sparse, the Court was clearly influenced by the following factors in reaching its decision:

- (as is common) the articles of association clearly distinguished between the event of redemption, which was expressed to occur on the dealing day, and the subsequent payment and receipt of redemption proceeds, which could occur later; and
- the reference to redemption requests being "honoured within seven days of receipt" was, in the Court's view, a reference to the honouring by way of payment.

The Fund's articles of association also contained a customary "cessation of rights provision" which stated that, upon the redemption of a share, the redeemed member "ceased to have any rights" with respect to the redeemed shares except the right to receive the redemption proceeds and any unpaid dividends. The BVI Court applied this article and, as a result, held that Western Union ceased to have any rights with respect to its shares on 15 September, 2008 other than the right to receive the \$298m of redemption proceeds as a creditor of the Fund.

Unfortunately, it does not appear to have been argued, and the Court did not consider, whether the redemption by Western Union in fact occurred on the basis of a mistake of fact as to NAV as at September 15, 2009. This may have been a basis upon which the Fund could have argued that the redemption proceeds owed to Western Union should be readjusted to reflect the "true" NAV as at that date. Assuming the true NAV of the Fund was diminished as soon as Lehman Brothers filed for bankruptcy, such an approach may have provided a basis for which the Fund could have effectively *pro rated* its remaining assets between all shareholders, irrespective of whether or not they had already redeemed their shares.

Section 197 of the Insolvency Act, 2003

Section 197 of the BVI Insolvency Act, 2003 provides that neither a shareholder nor a past shareholder of a company can claim in the liquidation of the company for a sum due to him "in his character as a member, whether by way of dividend profits, *redemption proceeds* or otherwise" (emphasis added). The purpose of this section is to preserve the priority of unsecured creditors over shareholders who may also be owed a debt, for example, as a result of a dividend. The section then goes on to say that any such sum owed to a shareholder will be taken into account in adjusting the rights between shareholders.

Rather surprisingly, the BVI Court held that Western Union's claim to its redemption proceeds was not being made in its "character as a member" and that section 197 therefore did not apply to the payment of the redemption proceeds. The key reason given for this conclusion was that Western Union ceased to be a shareholder of the company on the dealing day when the redemption occurred in accordance with the "cessation of rights provision" in the articles of association.

As the BVI Court acknowledged, the consequences of this interpretation of section 197 were that a redeemed shareholder could claim for its redemption proceeds in the liquidation on an equal footing with all other unsecured creditors of the Fund.

Appointment of Liquidators

Interestingly and apparently out of necessity, the only ground Western Union based its application to appoint a liquidator was that it was just and equitable – more specifically, on the basis that the Fund had lost its “substratum” or purpose. The Court agreed that the Fund had no commercial future and, that accordingly it had lost its substratum. However, a number of detailed arguments were made about whether or not the Court should exercise its inherent discretion to appoint a liquidator.

Most importantly, the Fund and the FSC argued that a BVI liquidator should not be appointed because proceedings to distribute the remaining assets of the Fund were already taking place in the United States and that these proceedings represented an alternative and preferable remedy to the appointment of a liquidator in the BVI. As stated above, the evidence suggested that any distribution in the United States proceedings would be made *pro rata*, regardless of the strict contractual rights of particular investors. In contrast, the BVI Court acknowledged that those investors who had successfully redeemed their shares prior to the calculation of NAV being suspended would be entitled to be paid-out in priority to those investors who were still shareholders, with the consequence that little would remain for the non-redeemed shareholders.

The Fund also argued that it was unlikely that a BVI liquidator would get Chapter 15 recognition in the United States because the Fund’s centre of main interests (“COMI”) were not located in the BVI. As a result, a BVI liquidator would have difficulty obtaining the assistance of the US courts and the existing US proceedings were therefore better able to deal with the distribution of the remaining assets in the US bank account.

The BVI Court rejected these submissions and appointed a liquidator to the Fund on the basis that it was just and equitable to do so. In particular, the Court noted that:

- it was wrong in principle to deny Western Union its right to have a liquidator appointed simply because foreign proceedings in respect of the same matter were ongoing – it was of the highest importance that shareholders and creditors of BVI companies had the right to have their rights determined in accordance with the laws of the BVI;
- this was particularly the case when such foreign proceedings threatened to deprive Western Union of its rights and receive only a fraction of what it was entitled to receive in a liquidation under BVI law; and
- while Chapter 15 recognition may not be available, a BVI liquidator could still attempt to collect the balance of the Fund bank account in the United States (even though the US courts would grant the liquidators no assistance if creditors had already been granted rights over that bank account). However, the BVI Court did tacitly acknowledge that in practice the liquidation would be carried out pursuant to the US proceedings as a result of the difficulty a BVI liquidator would likely have in getting Chapter 15 recognition.

Commentary

Disappointingly, the BVI Court did not refer to the Cayman Islands Court of Appeal case of *In re Strategic Turnaround Master Partnership Limited* (or the follow-up case of *In Re Matador Investments*) and, in certain respects, its decision fits uncomfortably with the conclusions in that case. While each case turns on their facts and the precise construction of the particular articles of association in question (and both cases ultimately concluded that a redeeming shareholder becomes a creditor of the Fund on the dealing day), the cases adopt fundamentally different approaches to when a redeeming shareholder ceases to have rights as a shareholder.

On the BVI Court's analysis, this happens on the dealing day itself. On the Cayman Court of Appeal's analysis, redemption is a longer process with distinct stages and a redeeming shareholder cannot properly be regarded as fully redeemed until the shareholder has received the redemption proceeds and the shareholder's name has been removed from its register of shareholders. This is despite the fact that the articles of the fund in *Strategic Turnaround* also contained a "cessation of rights" provision.

In some respects, the decision of the BVI Court should be welcomed. One of the difficulties with the decision in *Strategic Turnaround* is that there is significant uncertainty about precisely what membership rights a shareholder retains until his name is removed from the register of members. The certainty provided by the approach taken of the BVI Court is preferable. However, the fact *Strategic Turnaround* was not considered in *Reserve Fund* and the limited analysis given to the issue does give rise to uncertainty about the correctness of the decision and the legal analysis of the redemption process.

As a practical matter, the key decision of the BVI Court in *Reserve Fund* – namely that Western Union was a creditor for US\$298m – would not have been any different had the analysis in *Strategic Turnaround* been adopted. However, as the facts of *Strategic Turnaround* show, the exact point in time at which a shareholder ceases to have membership rights can be of crucial importance in other factual scenarios.

The approach in *Strategic Turnaround* would also have undoubtedly resulted in a different interpretation of section 197 of the Insolvency Act (indeed, the Cayman Court of Appeal considered the equivalent Cayman Islands' provisions and reached the opposite conclusion to the BVI Court). In the Cayman court's view, payment of redemption proceeds is simply part of the process by which a shareholder ceases to have the rights as a member. In the BVI court's view, the payment of redemption proceeds arises immediately upon the shareholder ceasing to have any rights as a member. While there is logic to this approach, it is remarkable that the BVI Court could conclude "redemption proceeds" owed to a redeemed shareholder are not paid in the shareholder's "character as a member" when section 197 expressly envisages that redemption proceeds owed to shareholders and past shareholders are covered by the section.

Finally, one cannot help feel how unfair it is that shareholders who were quick to redeem on the news of Lehman's bankruptcy are put in such a vastly superior position to other non-redeeming shareholders as a matter of BVI law. As mentioned above, it was not argued and the BVI court did not consider whether the NAV of \$1 calculated on the September 15 redemption day was done on the basis of a mistake of fact. This may have provided grounds for the Fund to argue that the true amount of the debt owed to Western Union was in fact far less than the full \$1 per share it claimed. This is an approach that has been taken by numerous funds experiencing similar events during the financial crisis and effectively enables the fund to treat redeemed and unredeemed shareholders equally. While the approach has yet to be properly tested in the BVI courts, it may have offered an attractive alternative to what even the FSC recognised as the fairer US proceedings.

We understand the case is under appeal and it will be interesting to see how the higher courts approach these issues.

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