CAYMAN ISLANDS

The Distressed Hedge Fund

Dealing with a Cayman Islands Hedge Fund Blow up

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May 2007

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The shear amount of liquidity provided to the markets by Hedge Funds, and private equity vehicles, is clearly the greatest difference in this particular credit cycle when compared against the last. The Cayman Islands is home to the vast majority of offshore funds and recent figures suggest that approximately 8,500 are domiciled in the Cayman Islands.

So, what happens when these "Masters of the Universe" meet their "Nemesis". Hedge fund blow ups are not new. I was fortunate (perhaps unfortunate) to be involved in the first significant hedge fund disaster, Long Term Capital, back in September 1998. At that time, the distressed hedge fund was somewhat of a new anomaly in the world financial markets. The lesson that particular case taught to everyone was not, as a lender, to over expose yourself by failing to take adequate collateral for lending. The shock that Long Term Capital caused in the market was sufficient for all the major banks to review their lending policies to these new financial vehicles. As a result, when we have the next bout the major financial institutions of the world will be better prepared. Investors, may however, not be.

The Present Day

Hedge funds, and to a lesser extent, private equity vehicles, have significantly changed market dynamics. During the downturn in the last credit cycle, most financing, whether by way of debt or equity, was driven by traditional financial institutions with an ultimate duty to create, and indeed preserve, value for traditional shareholders. This more medium to long term aim is in sharp contrast with the business rational of a hedge fund and, indeed, its investors. Although investor "lock up" periods or fixed end funds are common, the ultimate economic rational of a hedge fund is short term absolute returns. In reality, this usually means absolute returns on a monthly or quarterly basis. To conclude, a hedge fund investment manager is under considerable pressure to invest the not inconsiderable sums usually under his custody in short term, high yield and, hopefully, liquid, investments.

The Secondary Debt Market

These new, highly liquid, short term strategised beasts have to a large extent created a highly liquid secondary debt market. The appearance of these new players has encouraged and developed the present status quo. It is extremely rare to find traditional financial institutions holding onto their debt. For the traditional financial institution taking advantage of this new liquidity, a far better model is to engage in the initial lending (thereby charging a significant fee) and, immediately thereafter, to pass on the debt to the hungry secondary debt market through a securitisation or other mechanism (for which it also charges a significant fee). In conclusion, in taking advantage of this new situation the traditional bedrock of prudent

lending by traditional financial institutions has now been lost. As they are able to pass on risk, and at the same time make more money, lending strategies have become more aggressive.

Hedge Fund Risk

So where does this leave the hedge funds? The availability of this debt on the secondary market has spawned what can only be described as a hedge fund feeding frenzy. The massive amounts of hedge fund liquidity all chasing a limited number of investment opportunities has, through normal supply and demand principles, caused hedge funds seeking their absolute returns to pay what could be described as "over the odds" for these debt instruments. Whilst in the present benign environment such issues can, to an extent, be papered over, what happens when the credit cycle does take its dip?

Recently in Europe, Standard & Poor reported that because of the high multiples in recent highly leverage deals entered into by private equity houses, a lot of whose debt finds its way onto the secondary market, the average debt payment burden was four times above the normal safe level. Furthermore, John Moulton, of Alchemy Partners has gone on the record as saying that across Europe he estimated default levels to rise from the current €3 billion to "anywhere between €10 billion and €40 billion over the next few years". There is currently €600 billion of highly leverage debt in European companies. In a recent report by Close Brothers it was noted that there had been a sharp increase in the issuance of high risk CCC rated debt between 2003 and 2006. This was on top of the growth of the European high yield market. Close Brothers noted that historically, one third of CCC rated bonds had defaulted after two years, with 44.7% defaulting after three years. They went on to predict that the default rate would start to pick up naturally from 2007 to 2008 even in a benign environment.

"*Even if overall macro economic conditions remain benign, the historical default rate of CCC rated bonds point to problems ahead. The decline of the debt markets in 2007/2008 would mean that many struggling companies would not be able to continue re-financing their way out of trouble as has been the trend of recent years*"

What Will Tip the Cycle

As there are massive amounts of liquidity in the market it is unlikely that the next "credit crunch" will come as a result of this liquidity drying up. As with all credit crunches, it is far more likely to come as a result of some extraneous event that dents investor/lender confidence. Once this happens what is likely to occur?

First, all financially challenged companies who have, as a result of available liquidity, been able to re-finance on onerous terms, will find themselves in financial problems. From the debt holders view their ability

to repay debt will be compounded by the debt structures presently being put in place and, in particular, through the use of second lien, PIK and mezzanine lending. The knock on effect of these defaults will be felt throughout the secondary debt market. A number of hedge funds, who paid over the odds for high risk instruments, will undoubtedly get caught.

Credit Derivatives – The Cure?

But won't the use of credit default swaps lessen the blow? In my view, credit default swaps are only likely to further complicate the position. In particular, the market appears to see the use of these instruments as being a way of "eliminating risk". Risk can never be eliminated. All the credit default swaps do is pass the risk on to some other entity. When you have hedge funds that are now underwriting credit default swaps, the financial model becomes horribly circular. In my view, credit default swaps will come back to bite their issuers especially as a result of the protection buyer not being able to deliver the underlying instrument or debt against which the protection is being sold.

The Blow Up

So what are the strategies professionals should adopt when a hedge fund implodes? To an extent, the strategy depends on the extent of the blow up and whether there has been any wrong doing by any of the agents of the fund.

The Out of Court Winding Down

Where a fund has lost money as a result of a trading strategy to such an extent that it is uneconomical for the fund to continue an out of court winding down may be an option. Amaranth is a prime example. If a fund can loose US$ 3 billion it may still be possible to manage the situation without recourse to a formal insolvency proceeding.

Normal Cayman Islands' hedge fund articles contain a number of provisions that allow the fund effectively to shut up shop. In particular, hedge fund articles always contain a provision allowing the directors when they are of the view that it is in the best interest of the fund, to suspend net asset value ("NAV") calculations, dealing dates (days where investors are able to redeem their shares) and redemption payments in respect of any previously accepted redemption. This is a relatively simple procedure and merely requires the directors, acting in accordance with their fiduciary duties, to pass an appropriate board resolution. Once such a resolution has been passed investors rights to redeem are suspended thus avoiding the possibility of a "run on the bank". With the investors suitably at arms length, the investment manager can then take steps to liquidate the portfolio in an orderly manner for the best possible value. Once a portfolio has been

liquidated the fund compulsorily redeems out its investors on a pro rata basis. Thereafter, the fund is usually wound up on a voluntary basis and dissolved.

In the majority of trading losses cases, this particular strategy will be the most effective although one of the major issues that the investment manager/directors of the fund will face is credibility in winding down the portfolio. If an investment manager has already caused substantial losses to the fund it is unlikely that the investors or the board will have confidence in their abilities to liquidate the portfolio in an orderly fashion. To address this, we are seeing an increasing trend of the fund's directors bringing on board outside professional financial advisors to assist in decisions to liquidate positions for the board. Something that we have not, as yet, seen, but would clearly be a useful tool, is the constitution of informal advisory boards consisting of major investors in the fund, to work with the investment manager, the board of the fund and any outside financial advisors. At the end of the day, insofar as the investors have confidence in the process, the risk of litigation is reduced.

The Compulsory Winding Up of a Fund

In some situations, an orderly winding up of the fund on a consensual basis cannot be achieved. In particular, if there are any allegations of negligence, or indeed fraud, against the investment manager then an out of court process is likely to be inappropriate. Perhaps the best example of the problems in attempting to wind down a fund consensually is the case of the SphinX funds.

SphinX

Walkers were fund counsel to the SphinX Group ("SphinX"). The historical background facts were that as a result of an arrangement entered into by SphinX's investment manager, PlusFunds, Refco Inc ("Refco") had the benefit of a daily cash sweep whereby SphinX's cash was placed with Refco in brokerage accounts. Unknown to SphinX, Refco then used that cash to cover overnight positions.

Prior to the commencement of the Chapter 11 of RCM, SphinX was repaid monies it had in its brokerage accounts with Refco. Some two months later, SphinX was hit by a preference claim after the commencement of Refco Chapter 11. The value of that preference claim was in the region of US$ 312 million. In all, SphinX was, at that time, a fund with assets under management in excess of US$ 1.5 billion.

Because of the structure of SphinX, the effect the TRO granted in support of the preference claim was effectively to paralyse a significant proportion of the cash flow and investments of SphinX. Initially, the funds' advisors and its investment manager, PlusFunds, attempted to limit this impact by, first, creating side pockets in which to place affected assets (as they were now a illiquid) and to challenge the preference

claim itself. Matters went from bad to worse when Plus Funds itself filed for Chapter 11. As employees of PlusFunds were the only individuals with significant background knowledge of the business dealings of SphinX, this development was a severe blow, first, to the survival of the fund as a growing concern and, second, should the first not be achievable, the orderly winding down of the portfolio. Significant efforts were made to maintain certain key employees' involvement in SphinX structure and further efforts were made to find a replacement investment manager. Once no suitable replacement investment manager could be found, and because of an increasingly hostile group of investors, the only option was to place SphinX into a court based liquidation proceeding in the Cayman Islands. Liquidators, were, therefore, appointed to oversee the winding down of the portfolio.

How Does a Distressed Fund Commence its Own Liquidation Proceeding?

In hedge fund structures it is usual for there to be separate management shares. These shares hold all the voting rights; the investor shares having no rights of voting. The management shares are usually held by an offshore service provider sometimes under a STAR trust (a statutory based business trust under part 8 of the Cayman Islands Trust Law (2001 Revision)). Upon a fund blow up the trustee of the STAR trust has an obligation to vote the share in the best interest of the fund.

Accordingly, when one has a distressed fund the quickest procedure under the Cayman Islands' Companies Law (2004 Revision) ("the Law") is for the trustee who holds the management shares to vote those shares by way of special resolution to place the fund into voluntary liquidation with a recommendation that, pursuant to s.150 of the Law, the liquidation be taken under the supervision of the court. The effect of the court making such an order is to convert the voluntary, out of court, liquidation into a compulsory, court based, liquidation which, amongst other things, triggers an automatic stay of proceedings against the company.

COMI and Foreign Recognition

Whilst the administration and domicile of the fund may be in the Cayman Islands, in most structures it is usual for the assets, and the investment manager, to be elsewhere and, in particular, in the United States. In this situation, the liquidator must consider whether it is appropriate to seek recognition under Chapter 15 of the US Bankruptcy Code. For the Cayman Islands' domiciled hedge fund, under the new Chapter 15 regime, this has recently been somewhat of a hit and miss affair.

In SphinX, Judge Drain, in a much discussed decision, decided against granting the Cayman liquidators of SphinX foreign main proceeding recognition which would, amongst other things, have given them an

automatic stay of proceedings in the US. Instead, he chose to recognise them as a foreign non main proceeding. Most readers of this paper will be aware of the academic debate that the learned Judge's decision has generated and, in particular, whether he had jurisdiction to recognise the proceeding only as a foreign main proceeding or not at all. Legal commentators on the decision have fallen on both sides but all have questioned whether it was right for him to recognise the proceeding as a foreign non main proceeding.

However, in the recent case of Amerindo Growth Fund Ltd ("Amerindo), the same Judge recognised the Cayman liquidators of this fund as a foreign main proceeding. The Amerindo case can, on a factual basis, be differentiated from SphinX. First, none of SphinX's third party advisors/agents were resident in the Cayman Islands as its administrator and investment manager were US based. In all, the fund was only domiciled in the Cayman Islands. Accordingly, there was a strong argument that the COMI of the fund was not in the Cayman Islands.

Amerindo, being Cayman domiciled, also had its administration services conducted in the Cayman Islands by a division of a large financial institution. All the fund's books and records were in the Cayman Islands and the redemption/subscription for shares were administered there. Only the investment management function (which was arguably in the United States) was off island along with its assets which were held in a brokerage account in New York.

Foreign Recognition Going Forward

The decision in the SphinX case throws up an interesting conundrum for the future. A fund's blow up is usually dealt first with through the funds' advisors in the Cayman Islands who, thereafter, bring on board US counsel. Doubt about obtaining a foreign main proceeding recognition in the US may seriously impact the ability of the liquidator to take control of the affairs of the fund, make an orderly winding up of its affairs and make distributions to shareholders. How can this COMI issue be addressed? My view is that in circumstances such as SphinX, and unless and until there is a significant body of US Chapter 15 case law supporting the recognition as a foreign main proceeding a Cayman Islands' hedge fund insolvency, there may be grounds for adopting the ICO Global/Fruit of the Loom/Enron model in placing the fund into a debtor in possession Chapter 11 proceeding in the US and to have a "soft touch" provisional liquidation of the fund in the Cayman Islands. The new insolvency law that is due to be brought into the Cayman Islands' statute book in the not too distant future will specifically provide for the appointment of provisional liquidators if such an appointment would lead to "a better realisation of assets".

Conclusion

To conclude, we are all living in interesting times and the level of private equity/hedge fund activity in the M&A and secondary debt markets is, in my view, "music to the ears" of insolvency practitioners. Hedge funds, because of their prominent role and the risks that they are bound to take due to their absolute return strategies, will be inextricably caught up in any downturn.

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