



25 May, 2015

## Cayman Islands Court of Appeal issues judgement on Enforceability of Investor Side-Letters

The use of investor side-letters to vary the offering terms of an investment fund is perceived to be part and parcel of the private fund industry. Investors seek to negotiate specific concessions from asset managers and the funds that they operate in order, typically, to reduce management and performance fees, to obtain more favourable liquidity and access to reporting and in some cases to further restrict the investment policy limitations applicable to the manager in pursuing the objective of the fund. Given the widespread use of such documents, a recent finding by the Cayman Islands Court of Appeal (“**Court of Appeal**”) provides useful practical guidance for both investors and asset managers alike with respect to the use of side-letters and their enforceability.

In *the Matter of Lancelot Investors Fund, Ltd (in Official Liquidation)*<sup>1</sup>, KBC Investments Limited (the “**Beneficial Owner**”) had entered into a side-letter agreement (the “**Side-Letter**”) with Lancelot Investment Management LLC (the “**Investment Manager**”) which acted as investment manager to Lancelot Investors Fund, Ltd, a Cayman Islands domiciled private fund structure (the “**Fund**”). The Beneficial Owner had invested in the Fund via its custodian, Fortis Bank (Cayman) Ltd (“**Fortis**”) and Fortis was the registered owner of the shares in the Fund. The Side-Letter contained a variation of the liquidity provisions applicable to the shares in the Fund held by the Beneficial Investor though Fortis, to allow those shares to be redeemed notwithstanding the applicable lock-up periods described

<sup>1</sup> CICA 27/2013 (was FSD 87 of 2011)

For further information on any of the services provided by Dillon Eustace in the Cayman Islands, please contact:



Jonathan Law  
[Jonathan.law@dilloneustace.ie](mailto:Jonathan.law@dilloneustace.ie)  
DD + 1 345 949 0022



Shane Geraghty  
[Shane.geraghty@dilloneustace.ie](mailto:Shane.geraghty@dilloneustace.ie)  
DD + 1 345 949 0022

in the Fund's confidential offering memorandum (the "**Offering Memorandum**").

In October, 2007, Fortis issued a letter to the administrator of the Fund, Swiss Financial Services (Bahamas) Ltd ("**SFS**") requesting a redemption of shares in the Fund to be effected on 31 December, 2007 (the "**Redemption Request**"). SFS processed a partial redemption of the shares and indicated to Fortis that the balance of the unredeemed shares included in the Redemption Request could not be processed as those shares were subject to the lock-up requirements provided for in the Offering Memorandum. Accordingly, no further redemption of shares took place.

On 27 September, 2008, the Fund suspended share redemptions after it was discovered that the Fund was in fact a Ponzi scheme following an F.B.I investigation into the activities of an entity called Petters Group Worldwide. The assets of the Fund were used to purchase promissory notes which related to supposed inventory financing deals entered into for the benefit of Peter Company Inc. ("**PCI**"). It was subsequently discovered that PCI was in fact part of a fraudulent scheme and that there was no inventory financing schemes, nor any inventory to support the issuance of the promissory notes. Following the discovery of the fraudulent nature of PCI, in December, 2008 the Fund became subject to an order for winding-up and an official liquidator (the "**Liquidator**") was appointed to the Fund.

In 2009, Fortis submitted a proof of debt for the balance of the unredeemed shares in the Fund. Subsequently, the Liquidator notified Fortis of the rejection of the proof of debt (the "**Rejection**") for a number of reasons, including *inter alia* that the redemption request was correctly refused on the basis of the lock-up provisions disclosed in the Offering Memorandum and because the amendment purported to be implemented by the Side-Letter was ineffective in respect of the remaining unredeemed shares.

As a result of the Rejection, the Beneficial Owner sought a decision from the Cayman Islands Grand Court. In his judgment Quin J. held that:

- (i) the unredeemed shares in the Fund were still legally held by Fortis and as a consequence, the Beneficial Owner had no standing to challenge the Rejection;
- (ii) the Side-Letter was not enforceable on the basis that the parties to it did not have the requisite authority or standing to enter into the Side-Letter on the basis that:
  - (a) any side-letter which attaches rights to the shares in the Fund could only be enforced if such side-letter was entered into by the registered owner of the relevant shares and not the Beneficial Owner and the Side-Letter had not been ratified by Fortis as registered owner of the shares; and
  - (b) the Investment Manager was not authorized by the Fund to enter into the Side-Letter and therefore did not have the requisite authority to bind the Fund to the terms thereof.

- (iii) the Redemption Request could not be treated as a valid request to redeem on the first date permitted by the Offering Memorandum and that an acknowledgment of a partial redemption by SFS did not amount to an acceptance of the request that was capable of binding the Fund.

The Beneficial Owner appealed the decision to the Court of Appeal and its decision was released on 27 April, 2015. The Court of Appeal dismissed the Beneficial Owner's appeal unanimously but the judgment has also clarified certain aspects of the decision of the Grand Court at first instance.

## Court of Appeal Decision

The Court of Appeal held that the fact that the Beneficial Owner was a signatory to the Side-Letter was not necessarily a total impediment to the enforcement of its terms and provisions.

### *Assignment of dividend right in liquidation*

In general, it is accepted that only a registered shareholder may issue proceedings to vindicate their rights as a shareholder, however, once the Fund entered into the liquidation process, all claims to redemption proceeds become provable and the various claims against the Fund ranked for dividend. In accordance with the Companies Winding Up Rules 2008, the right to receive a dividend is assignable (Order 18 rule 9(1)). Accordingly, Fortis would have been permitted to assign its proof of debt to the Beneficial Owner and as a consequence the Beneficial Owner would be entitled to be treated as a creditor and thereafter entitled to appeal against the Rejection.

### *Bare Trustee and equitable assignee*

The Court of Appeal further noted that Fortis was a bare trustee of the Beneficial Owner in accordance with the custodian agreement between Fortis and the Beneficial Owner and that upon the commencement of the liquidation process and Fortis becoming a proving creditor, there was no issue with the Beneficial Owner maintaining an action as an equitable assignee. The Court of Appeal held that the Beneficial Owner was in principle entitled to maintain a claim as equitable assignee of the benefit of Fortis' proof of debt and as a result had standing to appeal against the Rejection, subject to Fortis being joined as the assignor. The evidence presented being that there was no good reason to refuse permission for Fortis' joinder. In addition, the Court of Appeal further stated that in the circumstances, the Side Letter could only be construed as to be made on Fortis' behalf and the Redemption Request and proof of debt were explicably only on the basis that Fortis had the benefit of the Side-Letter, which it had accordingly ratified by its conduct.

The Court of Appeal's findings will be of assistance to beneficial owners of shares in a liquidation scenario on the basis that it potentially opens up an avenue for contracts that would be otherwise be unenforceable, being capable of being enforced by virtue of ratification by the conduct of a beneficial owner's custodian or nominee entity. While the principle that the rights attaching to shares may only be pursued by the registered shareholder has not been disregarded by the Court

of Appeal, there is some scope for the Cayman courts to potentially adopt a pragmatic approach to dealing with issues where beneficial owners may be otherwise prevented from petitioning the courts in similar circumstances.

#### *Ability of Investment Manager to bind the Fund*

With respect to the ability of the Investment Manager to bind the Fund to the terms of the Side-Letter, the Court of Appeal's decision will be of particular interest to investors and other investment managers. The Court of Appeal found that the Side-Letter was not capable of binding the Fund for a number of reasons. Firstly, the Offering Memorandum expressly provided for the ability to vary the relevant lock-up periods, but the Investment Manager was found not to have the requisite authority to enter into such an agreement and make such an arrangement with the Beneficial Owner. Secondly, it was found that none of the documentation relating to or actions on the part of the Fund provided any form of ostensible authority to the Investment Manager to cover something as fundamental as changes to the basis on which the Fund's capital could be withdrawn by the redemption of shares. Thirdly, it was articulated that the outside world would not generally regard an investment manager as having authority to transmit the decisions of the board of directors and anyone reading the Offering Memorandum would be aware that the Investment Manager was merely one of a number of persons dealing with the Fund's affairs. The fact that the Investment Manager had been 'let loose on investors' did not in the circumstances give it ostensible authority to take decisions about share redemptions on behalf of the Fund. Finally, the Court of Appeal found that the acknowledgements issued by SFS could not amount to ratification of the Side-Letter by the Fund on the basis that SFS was similarly not authorized to transmit the decisions of the board of directors of the Fund.

#### *Consequences for investors and investment managers*

The decision of the Court of Appeal with respect to the enforceability of side-letters has consequences for those seeking to enter into such arrangements and should be carefully considered in light of the dismissal of the Beneficial Owner's appeal. It is clear that the safest and most secure way to ensure the enforceability of any such side-letter arrangement is to have the legal owner of the shares and the relevant fund as parties to the side-letter, thereby removing any possible ambiguity as to authority to enter into such arrangements. However, given the practicalities of the management of investment funds and common market standard behaviour, it should be possible to remove any legal uncertainty with respect to the authority of investment managers to enter into side-letters on behalf of investment funds through the use of express authorities and powers being conferred through the relevant investment management agreements and specific resolutions of the relevant boards of directors providing the necessary authority to investment managers to enter into such arrangements.

On the basis of this decision, parties entering into side-letters should seek confirmation and evidence of authority to enter into such side-letters prior to the signing thereof so as to avoid any possible attempt to disregard such side-letters in future. Those entities with existing side-letters in

place may need to review these arrangements and if necessary seek confirmation or assurance that such authorities were valid at the time of the entering into such side-letters and determine if ratification is required in order to provide legal certainty.

**DILLON  EUSTACE****Dublin**

33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

**Cayman Islands**

Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

**Hong Kong**

604 6F Printing House, 6 Duddell Street, Central, Hong Kong. Tel: +852 352 10352.

**New York**

245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

**Tokyo**

12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.

**DISCLAIMER:**

This document is for information purposes only and does not purport to represent legal advice. If you have any queries or would like further information relating to any of the above matters, please refer to the contacts above or your usual contact in Dillon Eustace.

**Copyright Notice:**

© 2015 Dillon Eustace. All rights reserved.