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Managing Distressed  
Cayman Funds,  
Lessons Learned for New Funds  
and UK Tax Legislation Affecting  
Cayman Funds

A webcast hosted by:

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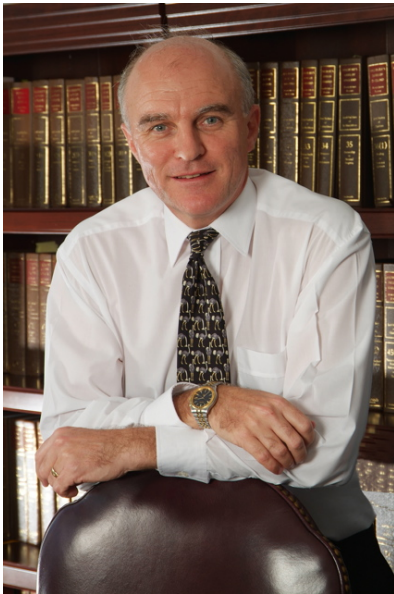


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## About today's Presenters



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## About today's Presenters



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## Agenda

### Part 1: Distressed Funds

Reasons for liquidity issues

Available Options

General points

Withholding redemption payments

In-kind payments

Redemption gates

Side Pockets



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## Part 2: Voluntary Liquidation as an option for Distressed Funds

Defining Voluntary Winding Up

When can a company be voluntarily wound up?

The effects of a Voluntary Winding up

Notice of Winding up

Declaration of Solvency

Court-supervised Liquidation

Conduct of Voluntary Liquidation



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## Part 3: UK Tax Legislation Affecting Cayman Funds

The New UK Fund Regime

EU Savings Directive in Relation to Funds

Transfer Pricing, Offer Documents, Corporate  
Residence and Tax Investigations



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# Distressed Funds



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## Reasons for Liquidity Issues

Liquidity issues might mean the Fund will have trouble meeting redemption requests from investors which can arise in a number of ways:

- **Illiquid underlying investments**, such as MBS, CDOs or investments into underlying Funds that are in trouble and cannot be redeemed out of;
- **Too many redemption requests**- investors want to withdraw cash for safety or to meet own liquidity needs, or because they want to preempt any issues;



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## Reasons for Liquidity Issues

- **Difficulty valuing assets-** the Fund may not be able to obtain an accurate NAV or NAV calculations may be suspended;
- **Lack of Credit-** banks are unwilling to lend on certain classes of assets.



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Even if a Fund is able to realise its liquid assets to pay pending redemptions, those investors that remain in the Fund could be prejudiced as the overall liquidity of the remaining assets could decrease. Any significant lack of liquidity in underlying assets has to be managed carefully in a way that is fair to all investors.



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## Available Options

What the Fund can do to address the issue will depend on its offering memorandum (“OM”) and Articles of Association (the bylaws of the Company). Typical options include:

- Withhold redemption payments or suspend NAV calculation;
- Pay redemptions in kind;
- Liquidate the fund;
- Impose a gate on redemptions.
- Create a side pocket;



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## As general points:

- Action should be driven by the directors unless the relevant discretion has been explicitly delegated to the manager;
- Important to keep investors informed. Most often the Fund's management team is best suited to manage the illiquid assets and investors are less likely to bring legal claims or force a court-supervised liquidation if they know what is going on.



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## Withholding Redemption Payments

Notwithstanding an investor may have submitted his redemption request for his shares to the Fund, the Fund can generally delay payment of some or all of the redemption proceeds. The amount withheld and the length of time it is withheld for, must comply with the Offering Documents and any relevant provision of the Articles of Association of the Fund.



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## Withholding Redemption Payments

- The Fund's OM will normally permit delay in payment of redemption proceeds, e.g.:

*"In the event that the Directors determine that special circumstances have arisen, including, but not limited to, default or delay in payments to the Fund by other persons, the Fund is entitled to delay payment of redemption proceeds equal to the proportionate part of the net assets of the Fund represented by the sums that are the subject of such default or delay."*



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## Withholding Redemption Payments

- If a delay in payment is not permitted at the discretion of the directors the alternative is to suspend NAV calculation or suspend redemptions. Funds are invariably entitled, by provisions in the OM, to suspend NAV calculation and some funds have the power to suspend redemptions without having to suspend the NAV. This latter power can be useful because it enables the NAV still to be calculated for purposes of subscriptions and determination of fees.



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## Withholding Redemption Payments

The effect is that pending redemptions will not be paid and new redemption requests will not be accepted by the Fund:

*"The Fund may withhold payment to any person whose Participating Shares have been tendered for redemption until after the suspension has been lifted. Notice of any suspension will be given to any Shareholder who has tendered his Participating Shares for redemption and to whom full payment of the redemption proceeds has not yet been remitted. If a redemption request is not withdrawn by a Shareholder following notification of a suspension, the redemption will be completed on the basis of the net asset value per Participating Share of the relevant Class on the Valuation Date immediately following the end of the suspension."*



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## Withholding redemption payments

Board resolutions and investor notification are required in the event of the suspension of the NAV calculation or delay in payment of redemption proceeds. If NAV calculation is suspended, all investors should be told. It is arguable that all investors should be told if a payment is withheld without an NAV suspension - this will depend on the circumstances. For example if a large investor has a partial redemption withheld, it will have notice that the Fund has redemption issues and will be able to request redemption of its remaining investment ahead of other investors.



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## Withholding Redemption Payments

- Potential legal issues arise if the Fund goes into liquidation between a redemption request and payment of the redemption proceeds.
- Recent decision of the Cayman Islands Court of Appeal in: *Re Strategic Turnaround Partnership Limited*  
Date: 12 December 2008



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## Withholding Redemption Payments

*Re: Strategic Turnaround Partnership, Limited* – 12 December 2008

- Certain Investors sought redemption of shares in the Fund.
- Redemption date set for 31 March 2008.
- Payment of 90% of proceeds due within 90 days (30 June 2008). Balance upon completion of audit.
- Redemptions suspended on 22 April 2008 - after the redemption date but prior to 30 June 2008 payment date.



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## Withholding Redemption Payments

*Re: Strategic Turnaround Partnership, Limited* – 12 December 2008

- Fund refused to pay any part of the 31 March 2008 redemptions because of suspension.
- Redeeming investor asserted that the Fund could not suspend redemptions after the redemption date and therefore the redemption proceeds (90% at least) were due.
- Redeeming investor petitioned for the winding up of the Fund on the basis of an unpaid debt.



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## Withholding Redemption Payments

*Re: Strategic Turnaround Partnership, Limited – Court of Appeal Decision*

- 1) The Court will look to the constituent documents to determine the rights and obligations of all parties in relation to the timing and effect of redemptions.
- 2) Redemption is a “process”. Until the redeeming investor is removed from the register and paid, “redemption” is not complete. Redeeming investor is still bound by the constituent documents.



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## Withholding Redemption Payments

*Re: Strategic Turnaround Partnership, Limited – Court of Appeal Decision*

- 3) Redeeming investor will become a “creditor” as at the redemption date even though the debt may not be due. Redemption amount becomes a (future) liability of the Fund and must be accounted for.
- 4) In a winding up, amounts due to redeeming investors will rank ahead of distributions to shareholders but behind debts owed to ordinary creditors.



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## In Kind Payments

- Payments in kind are only possible if permitted by the OM and/or Articles of Association. Included in our standard OM language:

*"Redemption proceeds may also be remitted in kind at the sole discretion of the Directors. "*

- Such action should be authorised by the directors and investors informed. Investors should be given an opportunity to withdraw redemption request.



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## In Kind Payments

- A major issue is likely to be accurate NAV calculation.
- Such action can give rise to unexpected issues- if the assets are participating shares in another fund, the investors might not be eligible investors or the shares might not be transferable. Assets might be in a jurisdiction that creates tax issues for the investor.



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## Redemption Gates

Redemption gates permit the Fund to set an upper limit on the percentage of the Fund's NAV that can be redeemed on any redemption date.



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## Redemption Gates

- Only possible if permitted by the OM and Articles of Association but it is a fairly common provision:

*"If redemption requests for more than ten per cent (10.0%) of the Net Asset Value of the Sub-Fund are received, then the Directors shall have the right to limit redemptions so they do not exceed this threshold amount of ten per cent (10.0%). Redemptions shall be limited with respect to all shareholders seeking to redeem shares as of a same day so that each such shareholder shall have the same percentage of its redemption request honoured ".*



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## Redemption Gates

- Investors have to be informed once implemented and there is a risk that this will trigger mass redemptions so that even if the redemption request is not met the investor will be at the front of the queue on subsequent redemption dates. Most gating language includes a provision to this effect, for example:

*"the balance of such redemption requests shall be processed by the Sub-Fund on the next day on which redemption requests are accepted, subject to the same limitation. On such day, such requests for redemption will be complied with in priority to subsequent requests."*



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## Redemption Gates

- The Fund has to ensure it can pay the relevant percentage of its NAV on each redemption date - in the above example this is 10%. Funds that have toxic assets like MBS, CDOs etc. may struggle to liquidate, or borrow against, these assets.



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## Side Pockets

- A side pocket is used to segregate illiquid assets from the main asset pool of the Fund. Separate shares are issued for the side pocket and distributed to redeeming investors as an in-kind payment. The investor will receive part of his redemption payment in cash from the liquid part of the Fund, and shares in the side pocket for the remainder.



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## Side Pockets

For example if the Fund is 90% liquid and 10% illiquid, an investor redeeming \$100 would receive \$90 cash and \$10 worth of shares in the side pocket. Those shares will be redeemed by the Fund as the underlying assets are liquidated.



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## Side Pockets

- The illiquid assets are typically moved into the side pocket as redemption requests are received, so in the above example the Fund would transfer \$10 worth of illiquid assets to the side pocket at the same time as it paid out the \$90 and issued the side pocket shares to the investor.



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## Side Pockets

- In order to ensure investors with side pocket shares are paid sequentially, a new side pocket can be created for each redemption date. As the illiquid assets are realised, the side pockets will be redeemed in the order they were created with the investors within each side pocket ranking equally.



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## Side Pockets

- If the Fund's OM permits, a side pocket can be established within a Fund as a separate class of shares. The Fund's OM must also permit the shifting of assets from the main pool into the side pocket. In this scenario the side pocket will be created by board resolution. It is recommended that there is general language in all offering memoranda enabling the establishment and use of side pockets if necessary.



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## Side Pockets

- If the Fund's OM does not expressly permit side pockets but does permit redemptions in-kind, and it is not prohibited by the Fund's investment objective, a side pocket can be set up by transferring the illiquid assets to a Special Purpose Vehicle, which will issue its shares to the Fund in return. The Fund then transfers the shares to the investor as an in-kind payment.



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## Side Pockets

If the Fund's investment objective does prevent the Fund investing through an SPV, this method can still be used but the SPV would have to issue shares directly to investors. This adds an extra step to the process as the consideration for the assets will have to be the SPV assuming the Fund's liability to the redeeming investor.



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## Side Pockets

If the SPV is set up as a Segregated Portfolio Company the side pocket can be used by more than one distressed Fund.



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# Voluntary Liquidation as an option for Distressed Funds



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## Voluntary Liquidation

On 1st March 2009 the Companies Law (2007 Revision) ("the Law") of the Cayman Islands was amended to bring into effect new laws and rules for the liquidation of companies in the Cayman Islands. The voluntary liquidation regime was changed in ways which mean a distressed fund may not now have the option of a voluntary liquidation.



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## What is Voluntary Winding Up?

When a company is wound up voluntarily the company appoints the liquidator and anyone, including a director or officer of the company, may be a liquidator. This is in contrast to the situation where the Grand Court of the Cayman Islands makes an order that a company should be wound up where the Court appoints the liquidators and the liquidators will only be appointed if suitably qualified.



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## When can a company be wound up?

Section 116 of the Law sets out the circumstances where a company can be wound up voluntarily. The relevant sections in the case of Distressed Funds are:

- (c) if the company resolves by special resolution that it be wound up voluntarily; or*
- (d) if the company resolves by ordinary resolution that it be wound up voluntarily because it is unable to pay its debts as they fall due.*



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## What is the effect of a Voluntary Winding Up?

The company shall cease to carry on its business unless doing so is beneficial for its winding up but the corporate powers and status continue until the company is dissolved.



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## Notice of Winding Up

Under Section 123 of the Law there is a requirement on the Liquidator or , if there is no liquidator, the directors of the company to give notice of the voluntary winding up.

Notice must be given to the Registrar of Companies and, in the case of a company carrying on regulated business, to the Cayman Islands Monetary Authority. In addition the Notice must be published in the Cayman Islands Gazette. The necessary notice must be given within 28 days of the passing of a resolution for winding up.



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## Notice of Winding Up

It is also now a requirement that within 28 days of the passing of a resolution for winding up commencement of a voluntary winding up the liquidator's consent to act must be filed with the Registrar of Companies and the director's declaration of solvency must be filed with the Registrar of Companies.

A director or liquidator who fails to comply with these requirements of the Law commits an offence and is liable to a fine of up to \$10,000.



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## What is a Declaration of Solvency?

Section 124 of the Law sets out what the directors must state.

*124. (2) A declaration of solvency means a voluntary declaration or affidavit in the prescribed form to the effect that a full enquiry into the company's affairs has been made and that to the best of the directors' knowledge and belief the company will be able to pay its debts in full together with interest at the prescribed rate, within such period, not exceeding 12 months from the commencement of the winding up, as may be specified in the declaration.*

It is an offence to knowingly make a false declaration and such person is liable to a \$10,000 fine or 2 years imprisonment.



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## When will a Court need to supervise the Liquidation?

Section 124 of the Law sets out the requirement to seek court supervision of a voluntary liquidation.

*124. (1) Where a company is being wound up voluntarily its liquidator shall apply to the Court for an order that the liquidation continue under the supervision of the Court unless, within 28 days of the commencement of the liquidation, the directors have signed a declaration of solvency in the prescribed form.*



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## Conduct of Voluntary Liquidation

The voluntary liquidator(s) shall conduct the winding up of the company's affairs and distribute its assets. The liquidator must summons a meeting of the company to report on the liquidation within 3 months and on every anniversary of the commencement of the liquidation and give an account of his acts and dealings and the conduct of the winding up. As soon as the company's affairs are fully wound up the liquidator must report at a general meeting on the conduct of the liquidation and how the company's property has been disposed of.



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## Conduct of Voluntary Liquidation

Questions arising during the course of the winding up can be referred to the Court for determination. The expenses of the voluntary winding up, including the liquidators' remuneration, are payable as a first priority out of the assets of the company. The rate and amount of the liquidators' remuneration shall be fixed and payment authorised by a resolution of the company.



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# Cayman funds and UK taxation

21 April 2009

TAX

# Agenda

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- **Cayman funds**
  - The new UK reporting regime
  - EU Savings Directive in relation to Cayman funds
  - Transfer pricing, offer documents, corporate residence and tax investigations



# Cayman funds

## And the new UK reporting regime

# UK offshore funds tax legislation

## Existing regime

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- **Why change?**
  - Simplification
  - Greater certainty for UK investors
  - Economic parity with existing UK regime for Authorised funds
  - There was an abuse of definitions so entities fell outside definition

# UK offshore funds tax legislation

## Existing regime

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- **Fund = offshore fund, if UK resident has “material interest” in offshore fund...**
- **Gain on disposal generally charged to income tax (40%)**
- **UNLESS offshore fund is certified as distributor status fund throughout entire ownership period**
- **Gain chargeable to CGT (18%)**
- **Tax charge deferred until exit**

# UK offshore funds tax legislation

## Proposed new regime - summary

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- **Characteristics based definition of an “OSF”**
- **Material interest test (7 year rule) abolished, new mutual fund definition introduced**
- **Reporting funds or non-reporting funds**
- **Apply to join reporting fund regime**
- **No requirement to distribute – but need to calculate reportable income**

# UK offshore funds tax legislation

## Entry into reporting fund regime

- Application to be made within 3 months of start of first period
- HMRC have 28 days to respond
- Existing funds: new regime for accounting periods starting on or after 1 October 2009
- Obligations
  - Prepare accounts in accordance with IAS or GAAP (which GAAP?)
  - Provide a calculation of reportable income (not UKEP)
  - Report income to investors
  - Provide information to HMRC

# UK offshore funds tax legislation

## New regime: other points

- **Restricted investments?**

- Historically there was a restriction on what distributing funds could invest in, e.g. limit of 5% in non-distributing funds
- New regime - no such restrictions
- BUT growth in investments in non-reporting funds will be treated as reported income on a mark to market basis (i.e. capital growth will be taxed as income) – subject to information held

- **Errors?**

- Historically a breach of the rules meant distributor status would be lost
- Now margin for error introduced and breach regime

- **Areas of uncertainty remain**



# Cayman funds and fund managers

Transfer pricing, offer documents, corporate residence and tax investigations

# Corporate residence - easy to manage....or is it?

- **We are referring to central management and control (“CM&C”)**
- **Directors might do all the right things....but it may not be enough**
- **How can CM&C change?**
  - UK usurper? Someone dictating the strategic direction of the fund
  - Underlying companies are managed by persons other than the board on the fund
  - Composition of the board means that majority of the decisions are made in the UK
- **Consequences - the fund is therefore UK resident and subject to UK taxation**
- **Investors will not be happy!**
- **Therefore need to consider who does what, where and how and the promises that are made in the offer documentation**

# Offer documents and transfer pricing

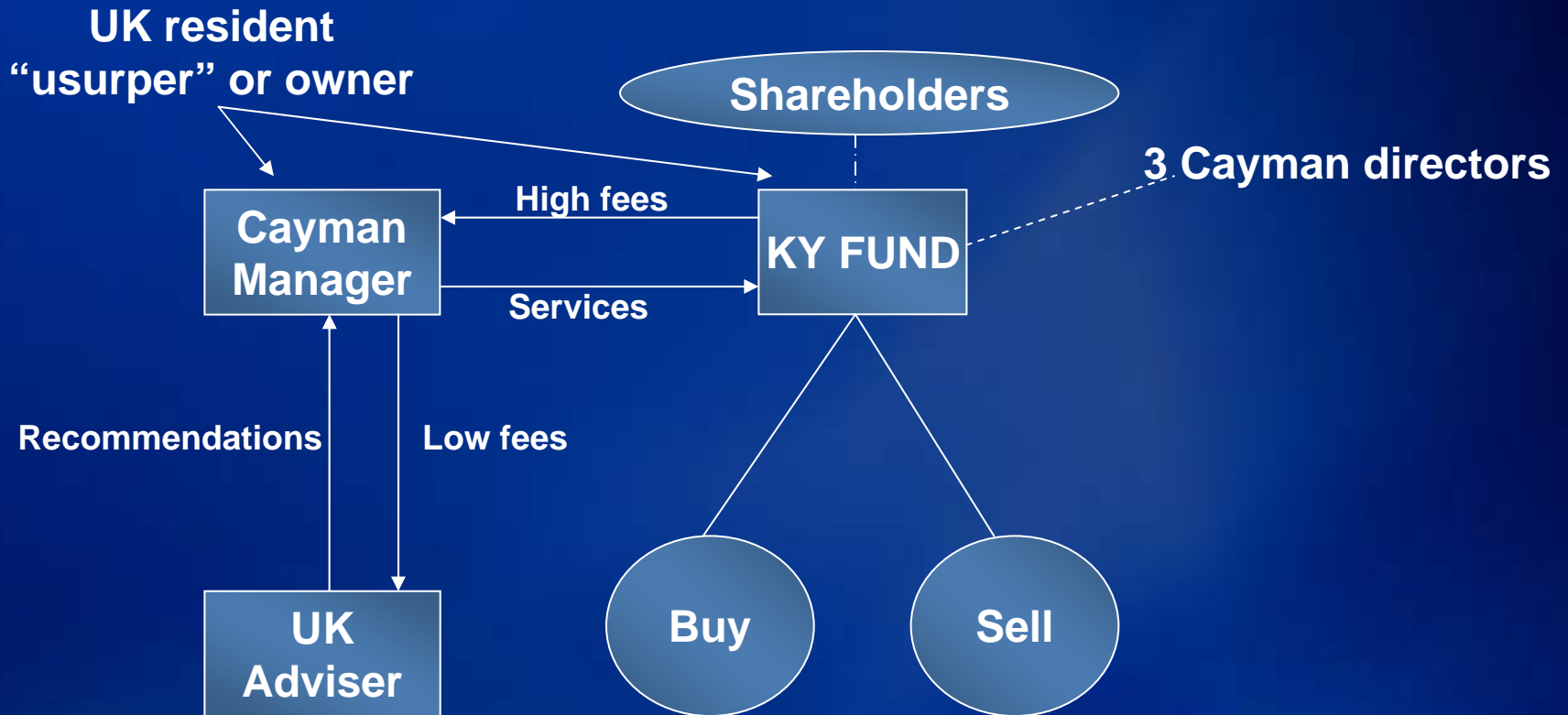
- **Offer documents**

- The statements made in offer documents can be detrimental
- “The Directors intend that the Fund will be centrally managed and controlled so that it does not become resident in the United Kingdom for United Kingdom taxation purposes.”
- Why? M&C is a question of substance, i.e. what actually happens
- In complex structures: Can directors sign up to this with conviction?

- **What about transfer pricing?**

- We need also consider the position of “connected” fund managers and UK investment advisers
- How the fund manager operates (i.e. what it does) does have an impact on the level of fees paid to the investment manager compared to performance fees received (in HMRC’s view).

# Manager and adviser are “connected”



# What are HMRC interested in?

- **Transfer pricing**
  - UK advisors and levels of fees received
- **Performance fees**
  - UK individuals owning Cayman fund managers - diversion of profits
- **Corporate residence**
  - Fund managers controlled in the UK
  - Funds themselves managed and controlled in the UK



# EU Savings Directive in relation to offshore funds

# EUSD

## Existing position

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- **EUSD applies to cross border interest payments to individuals**
- **Automatic exchange of information in Cayman**
- **Can apply to distributions/ redemptions by certain funds that invest in debt claims but only applies to UCITS/ UCITS equivalents**
- **Very few Cayman funds caught (1%)**

# EUSD

## Proposed new directive

- **Commission has suggested amending proposals to the EUSD to extend scope to:**
  - ALL funds that invest in debt claims, not just UCITS equivalents
  - Distributions – Funds with >15% invested in debt claims
  - Redemptions – Funds with > 40% invested in debt claims
  - Reduced to 25% in 3 years
- **Will Cayman implement new Directive?**
- **2013 or 2014 implementation?**

# Conclusion

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- **Rapidly changing environment**
- **Increased scrutiny from HMRC**
- **EUSD will mean increased administrative burden for some funds.**



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Thank you for your kind attention.

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