

Royal Court rules on loss of substratum in a Jersey fund

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The Royal Court has ordered the winding up of a Jersey closed end fund on just and equitable grounds on the basis of a loss of the fund's substratum. The Court first delivered judgment in August in the case, *EVIC v Greater Europe Deep Value Fund II Limited*, and following a further hearing last month ordered the winding up of the fund. A further reasoned judgment will follow.

The Facts

The Plaintiff (**EVIC**), represented by Ogier, was a significant minority shareholder in the Defendant (the **Fund**). The Fund had a limited life of five years, split into two distinct periods: a three year "*Investment Period*", and then a two year "*Wind-Down Period*" in which there was a duty for the Fund to endeavour to realise the assets in the Fund and distribute cash to investors.

As the Fund entered its Wind-Down Period the Directors and Investment Advisor articulated concerns about the short-term value of the Fund's investments in Russian real estate projects (the **Assets**) and proposed an extension to the Wind Down Period. The extension required the support of at least 75% of the Shareholders of the Fund. The Fund sought such approval, but failed to get it. As an alternative, the Fund proposed a "*Redemption-in-Kind option*". The key features of this proposal were:

- the Fund would create and hold shares in a new SPV (Phoenix);
- Phoenix SPV was to have a fixed life of three years (with up to 3 one year extensions) and be run on substantially the same basis as the Fund;

- the Fund would transfer to Phoenix SPV the real estate assets and \$10m of realised cash for any "*follow-on investments*" in relation to the real estate assets;
- the Fund would then redeem Shareholders in the Fund either in specie by transferring to them Phoenix SPV shares or alternatively in cash on the basis of the short-term liquidation value of the real estate assets minus a 30% discount.

The Arguments in brief

EVIC sought the just and equitable winding up of the Fund pursuant to Article 155 of the Companies (Jersey) Law 1999 (the **Law**) (and/or for relief for unfair prejudice pursuant to Articles 141 to 143 of the Law and/or breach of contract). EVIC argued that, as the Fund was closed ended, its substratum would be lost at the end of the Wind-Down Period absent an approved extension, and that the Redemption-in-Kind option was an artificial means of extending the life of the Fund without the necessary majority. EVIC also challenged the \$10m cash transfer as amounting to a new investment made outside the investment period and therefore in breach of the Prospectus and Articles of Association of the Fund (**Articles**).

The Fund maintained that the proposal was valid under the Articles. It argued that a true redemption in specie of the underlying interests in the Assets was not appropriate, and that Phoenix SPV was therefore a mechanism of convenience to pool the Assets. Accordingly it was not an attempt to circumvent the extension provisions because there was the option to cash out in full.

Breach of the Articles and Prospectus of the Fund

Regarding the interpretation of Fund documentation, the Court held as follows:

- in a closed-end fund, investors will typically have no redemption right and therefore provisions as to when investment returns will be made are important;
- (applying English law principles that the label given to a defined term is an aid to the construction of its definition), that to "invest" means to put money into something offering potentially profitable returns and to "realise" means to sell and convert into money.

In considering "*follow-on investments*", the Court held that during the Wind-Down Period the Fund was contractually bound not to make any *new* investments, but could take steps to "*preserve, protect and enhance*" the assets of the Fund (including the expenditure of money) for the purposes of realisation of the Fund's assets. On that basis the investment of \$10m in Phoenix SPV was not a lawful "*follow-on investment*" as it was not being made with a view to realisation during the Wind-Down Period.

The Court also held that, given the emphasis on returning cash to Shareholders at the end of the

Wind-Down Period, a redemption-in-kind could only be made if assets could not genuinely be realised. Phoenix SPV was in fact a new asset holding structure (essentially a new fund) created during the Wind-Down Period, which sought to achieve *"precisely the same end"* as the extension. The construction of the Fund's documents, advanced in support of the proposal, made no commercial sense.

The Court also held that with Wind-Down Periods of this type *"there is an implied term of the Prospectus that the Fund would not take any steps which would make the realisation of one or more of its underlying assets within the Wind-Down Period impossible or substantially more difficult"*. In this case, the transfer of the real estate assets into Phoenix SPV had *"both as its object and effect the deferment of any realisation of the underlying assets"*.

The cash alternative to the redemption-in-kind was held not to provide the Fund with any justification as there was no guarantee that a Shareholder opting for cash (albeit on the discounted basis) would receive cash. There had to be a balance between Shareholders who wanted to take a greater portion of their entitlement on redemption in Phoenix SPV shares and Shareholders who wanted less. If there was an imbalance, Shareholders could be forced to receive shares in Phoenix SPV.

Just and Equitable Winding up

Loss of substratum is a recognised ground for the granting of a just and equitable winding up order in Jersey. In the present case the Court concluded that loss of substratum arose *"...where it is impossible for a company to carry on the business for which it was established ... even if the directors or a majority of the shareholders wish the company to continue in business"*.

The Court was satisfied that the Fund's substratum had been lost in any event *"save to the extent that its formal winding up forms part of the Fund's business"*. The Court directed that the views of other Shareholders be ascertained on whether the winding-up should be conducted by Court appointed liquidators (as EVIC contended) or by the directors of the Fund and adjourned the proceedings. Following a further hearing the Court ordered on 4 December 2012 that the appropriate remedy was to appoint independent liquidators under Article 155 of the Law. A reasoned judgment is expected early in 2013.

Unfair Prejudice

The Court held in its judgment in August that its finding that the Redemption-in-Kind proposal was in breach of the Articles of Association and Prospectus was sufficient for a finding that EVIC's application under Article 141 of the Law was well-founded but in light of the appointment of the liquidators, no further relief was granted under this limb.

Conclusion

Directors of funds, and those advising them, need to give careful consideration to the terms upon which the fund in question is governed. In the current economic climate it may be that Directors are duty bound to consider ways to stave off potential losses and maximise returns for investors or shareholders. However, in adopting innovative strategies, Directors should always remember that they are constrained by the constitutive documents. In seeking to restructure the fund, to side-pocket or to adopt broad interpretations to clearly defined terms Directors should act cautiously.

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Meet the Author



Nick Williams

Partner

Jersey

E: nick.williams@ogier.com

T: [+44 1534 514318](tel:+441534514318)

Key Contacts



Edward Mackereth

Global Managing Partner

Jersey

E: edward.mackereth@ogier.com

T: [+44 1534 514320](tel:+441534514320)



Oliver Passmore

Partner

Jersey

E: oliver.passmore@ogier.com

T: [+44 1534 514247](tel:+441534514247)

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