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Fairfield Sentry and hedge fund clawback claims: the beginning of the end or the end of the beginning?

KEY POINTS

- The Court of Appeal of the Eastern Caribbean Supreme Court has given important guidance on certain core issues in the *Fairfield Sentry* case, an appeal from the BVI on claims by liquidators of offshore investment funds to recover monies from investors who redeemed prior to liquidation.
- The judgment indicates that many collapsed or stressed funds will retain a contractual right to restate historic NAV. However, it also determined that a restitution claim for repayment based solely upon a mistake as to the valuation of the redemption payment will fail.
- Clawback claims cover a wide variety of factual and legal circumstances. *Fairfield Sentry* only determines a narrow range of issues.

The ability of liquidators of offshore investment funds to assert "clawback" claims against pre-liquidation redeemers has been a controversial and divisive issue.

US bankruptcy or SIPA (Securities Investor Protection Act 1970) trustees have exercised statutory insolvency powers to assert clawback claims against investment fund investors for some time. The *Bayou* litigation in the US brought such claims to prominence, particularly by establishing the right of trustees to claim back fictitious profits from pre-insolvency redeemers regardless of whether the redeemer redeemed in good faith or for value.

The economic downturn in 2008 has provided the backdrop for clawbacks coming before the offshore courts, particularly in respect of collapsed funds which were unable to withstand losses magnified by leverage strategies or those which had been directly or indirectly involved in fraud. This article considers how the recent judgment of the Court of Appeal of the Eastern Caribbean Supreme Court in *Quilvest Finance Limited and others v Fairfield Sentry Limited (in liquidation)*, (unreported) 13 June 2012 will affect these claims.

CLAWBACK CLAIMS ARE NOT EQUAL

There is no unitary concept of a clawback claim; these claims cover a spectrum of circumstances. These range from cases in which investors have discovered that apparently significant profits were entirely fictional to cases involving investors who were aware of significant solvency issues at the time of the redemption request. The reasons for the collapse of a fund affect the competing interests in any claim. When a fund has used aggressive leveraging strategies, the parties with the principal interest in a liquidation typically will be the leverage provider creditors. When a fund has suffered over-reporting of NAV following fraud, the investors who have found their investments to be worthless often drive subsequent litigation.

Each offshore clawback judgment must be assessed in its jurisdictional context and in the context of the fund's constitutional documents. Any review of the post-2008 hedge fund case law shows how important the core fund documentation is to the outcome of the dispute and how extracting broad principles from specific cases can be dangerous. Small differences in an Articles of Association or a Private Placement Memorandum (PPM) have significant impact upon legal rights.

THE *FAIRFIELD SENTRY BVI* LITIGATION

The background to *Fairfield Sentry* is well known. Fairfield Greenwich Group ran feeder funds for third party managed single trading strategy funds. Fairfield Sentry Limited (the Fund), a BVI company, operated as a feeder fund for Bernard L Madoff Investment Securities LLC (BMIS). It was pleaded that 95% of the Fund's money was invested in BMIS.

After BMIS collapsed in December 2008 following the discovery of Bernard Madoff's fraud, it was clear that the assets of the Fund were worth far less than previously thought, and, on the Fund's pleaded case, for some time the shares of the Fund had a nil or nominal NAV.

The Fund entered liquidation in the BVI in July 2009. In early 2010 the liquidators obtained permission to bring clawback claims against investors who had redeemed, in whole or in part, their investment in the Fund prior to the collapse who received payments based upon a NAV calculated before Madoff's fraud was known. The amount claimed was in excess of $1bn and included redemptions made as long ago as March 2004.

THE PRELIMINARY ISSUES

At first instance, Bannister J observed that the Fund relied upon two claims based exclusively upon common law. First, it was claimed that the Fund was entitled to restitution as the redemption monies were paid pursuant to a mistake of fact because the NAV was at material times a nil or nominal sum rather than the value calculated by the administrators. Second,

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it was alleged that the Fund was entitled to set aside the redemptions and seek restitution of the redemption monies on the basis that the payments were effected while both parties were acting under a mutual mistake.

No allegations were made based upon contract law, company law or insolvency law. No allegation of fault was made against any of the defendant redeemers, nor was there any allegation of knowledge, actual or constructive, of the financial problems at either Fairfield Sentry or BMIS. This was a case brought solely on the basis of recovery of monies paid pursuant to a mistake.

The court determined two preliminary issues. First, whether certain documents provided by the Fund or its administrators could constitute a "certificate" within the meaning of the Fund's Articles and if so whether this precluded the Fund from asserting that the NAV as calculated was incorrect (the Certificate Issue). Second, whether defendant redeemers in surrendering their shares gave good consideration for the payment by the Fund of the redemption monies, and if so, whether that precluded the Fund from asserting that the money paid to the redeemers exceeded the true redemption price such as to render any excess payments irrecoverable (the Good Consideration Issue).

TWO FIRST INSTANCE JUDGMENTS

The preliminary issues were determined by Bannister J in a judgment dated 16 September 2011 (the First Judgment).

The majority of the analysis considered the Certificate Issue, Bannister J finding that none of the documents constituted a certificate under the Fund's constitutional documents.

The Good Consideration Issue was dealt with in just three paragraphs. The redemption process was considered to be a new contract between the Fund and the investor. The court found that the making of the payment pursuant to a contractual arrangement which was effective at the date of the transfer was a bar to restitution on the basis that the recipient provided good consideration for the transfer. The court applied a relatively traditional approach to Goff J's judgment in *Barclays Bank Ltd v WJ Simms Son & Cooke Southern Ltd* [1980] QB 677.

Following the first judgment, the defendants asked that the actions be dismissed. This required further argument on the mutual mistake allegation. By a ruling dated 10 October 2011 (the Second Judgment), Bannister J confirmed that the defendants were entitled to judgment on all claims.

The second judgment focussed on the plea that there was a mutual mistake which could impugn the validity of the redemption contract between the investor and the Fund. Proceeding on relatively well-established principles, Bannister J found that if a payment was made pursuant to a subsisting contract such that the payment could not be challenged by reason of the provision of good consideration there could not be a restitutionary remedy based upon the mistaken payment unless the contract itself was void at the time of the payment. Relying upon *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd, (The Great Peace)*, [2002] EWCA Civ 1407; [2003] QB 679, the learned judge was of the view that the mistake as to the effect of the Madoff fraud on the underlying assets of the fund was not the type of mistake which could render the underlying contract void, that contract being one for the provision of investment services by the Fund to its investor. The claims therefore had to be dismissed.

The Fund sought an adjournment, in the hope of being able to put forward a new pleaded case against certain redeemers alleging those redeemers had actual or constructive notice of the misconduct of Madoff and/or oversight problems at Fairfield Sentry. This allegation would have moved the case considerably along the clawback spectrum and opened up new causes of action and additional arguments as to the merits of the restitution claims. The adjournment was refused.

The Fund appealed the orders made as a result of the first and second judgments.

THE COURT OF APPEAL JUDGMENT

By a ruling dated 13 June 2012, the Court of Appeal affirmed the rulings below, albeit with some differences in analysis. Two judgments were handed down with the concurrence of all three judges; Mitchell JA (Ag.) dealt with the Certificate Issue and Pereira JA reviewed the Good Consideration Issue.

On the Certificate Issue, Mitchell JA(Ag.) found previous cases which indirectly considered fund valuation certification of little assistance. His judgment was primarily a review of the Articles of the Fund. He concluded that none of the documents in question were certificates. The directors had engaged the administrator to calculate the NAV. There had not been a delegation of the power of the directors to issue a certification of the NAV. In order to constitute a binding certificate a document had to purport to be a certification by the directors, either by the directors directly, or if there was a power to delegate certification, by someone to whom the power of certification had been delegated [36-37]. As the redeemers could not identify a document as a certificate which had been issued by a party authorised to provide a certificate, the redeemers' argument had to fail. It was noted that the inclusion of a certification provision contemplated that the Fund could re-calculate a NAV since otherwise there would be no reason to provide for certification [38].

On the Good Consideration Issue, the Fund conceded at the appeal that if there was a new contract the monies paid to the redeemers would have been irrecoverable [60]. The Fund's case before the Court of Appeal was that the shares had no value at the time of the redemption so no debt was owed by the Fund to the redeemer and there was no debt to discharge by reason of the redemption request [62]. The Fund did not argue that the subscription contract should have been avoided [74] and [83].

The court considered it made no difference whether there was a new redemption contract or one investment

contract [79]. Pereira JA did not formally disapprove the new contract approach of Bannister J. However by stating that her decision took a "different route" from the court below, it can be inferred that the court preferred the argument that the redemption process was part of a single contract of investment between the shareholders and the Fund rather than a new contract for the sale of the shares.

The redemption provisions in the Articles gave rise to a valid contractual debt owed by the Fund to the redeemer upon the right of redemption accruing, the amount of that debt being determined when the NAV was calculated [79]. As the Articles gave rise to the debt, and since the contractual validity of the subscription and the Articles were not challenged, there was good consideration for the redemption payment [87].

Citing *Barclays Bank v Simms, The Great Peace* and *Deutsche Morgan Grenfell plc v IRC* [2006] UKHL 49, [2007] 1 AC 558, HL(E), the court considered that unless the underlying original contract which gave rise to the contractual debt was void or had been avoided prior to payment, the good consideration defence would bar a restitution claim. The court found that the underlying investment contract could not be impugned on the basis of mutual mistake. Central to the rejection of the mutual mistake argument was the fact that the PPM included disclosures as to the risk of misappropriation of assets in the custody of third parties. As the contract had specifically contemplated the risk, *The Great Peace* barred any third party fraud forming the basis of a mutual mistake plea.

The Court of Appeal also upheld the refusal of the adjournment application [91].

WIDER IMPACT OF *FAIRFIELD SENTRY*?

There are many potential or pending clawback actions which are going through various stages of investigation. What impact will the *Fairfield Sentry* judgment have on these claims?

In the long term the Court of Appeal's judgment, and more specifically the findings on the Certification Issue, may give a significant boost to the prospects of success for liquidators seeking recovery of monies from redeemers on claims with more favourable facts.

First, the determination of the Certificate Issue in favour of the Fund indicates that it will be difficult for redeemers to assert a defence alleging that NAV statements and other standard documentation provided by a fund to investors constituted a certificate which would be binding on the fund. Much has been written about the arguments that could be made by both parties if a redeemer could identify a document which would constitute a certificate, but *Fairfield Sentry* suggest that these arguments may not arise in many cases.

It is clear from the analysis in *Fairfield Sentry* that each case will require a close consideration of the offering documentation and the fund's constitutional documents to determine both what is required for a document to be a certificate and crucially who is entitled to issue a certificate. It is in this second aspect that *Fairfield Sentry* is significant.

The *Fairfield Sentry* documentation appeared relatively standard and there was no indication in the judgments that there were any unusual provisions. In funds with similar articles, absent the direct provision by the directors of a document which purported to be a certification of the NAV or of the redemption value and absent a specific delegation of those powers to administrators, it will be difficult for redeemers to assert a certification defence.

Second, the determination of the Certification Issue may open up opportunities for liquidators of funds to formally restate historic NAVs and to seek to use that restatement to assert claims against redeemers for the difference between the original and restated NAV. The Court of Appeal noted that certification provisions presupposed that the fund could restate NAV [38]. The court's views on NAV restatement arguably run contrary to the decision of Bell J in *Re Stewardship Credit Arbitrage Fund Ltd* (2008) 73 WIR 136, esp [46-51] which took a negative view of the rights of a fund to restate NAV. This may be of great significance for partial redeemers in solvent but illiquid funds whose claims for their remaining investments may be set off against the historic over-payments.

Redeemer defendants will argue that *Fairfield Sentry* confirms that there is no basis for a claim in restitution in these circumstances, since the Fund argued in that case that the NAV would be restated at nil or a nominal value. However in the future funds may accept that there was a valid payment discharging a debt at the amount of the restated NAV and seek recovery of the amount of the payments above the restated NAV. If fund documentation specifically acknowledges the risk of third party fraud and provides for the possibility of restatement of the NAV, albeit indirectly through certification provisions, the argument would run that the arrangements between the parties contemplated a restatement of the NAV in circumstances involving the discovery of a third party fraud and recovery of overpayments.

The Good Consideration argument proceeded along traditionally accepted lines and the approach of Bannister J and the Court of Appeal on the restitution questions are not surprising. For common law claims in restitution against redeeming investors with no notice of financial problems based solely upon a mistaken overpayment, *Fairfield Sentry* indicates that these claims will face problems to get past summary disposal applications. Viewed from a common law perspective, these claims involved challenging facts for the Fund. The Fund did not allege that the redeemers had any actual or constructive notice of financial difficulties that were experienced by the Fund. Many of the claims involved redemptions made several years before Madoff's fraud was disclosed. Had the redeemer defendants lost this case then the scope of clawback claims on the basis of mistake would threaten to be very wide, subject, of course, to the availability of the defence of change of position.

It is important to consider where the claims in the *Fairfield Sentry* case fit in the

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clawback spectrum. The judgments make it clear that a sustainable allegation of fault would have given rise to a triable issue of the extent to which the fault of the redeemer would have negated any good consideration defence. In terms of common law claims in jurisdictions which do not allow alternative ways to run clawback actions, fault allegations are likely to be the next material battleground between liquidators and redeemers, and specifically a critical issue will be what must be pleaded in order to permit an allegation of redeemer fault to go to trial. That in turn may lead to divergence between the offshore jurisdictions, since the scope of a defendant's right to seek summary judgment varies significantly. One lesson from *Fairfield Sentry* may be that liquidators will be advised to use their statutory evidence gathering functions to collate information on fault issues or consider other options available to them such as the broad s 1782 processes in the US. There is, of course, a tension between delaying proceedings for information gathering purposes and the increased limitation risks for any claims.

There are other claim formulations which have not yet been before the offshore courts in the context of clawback actions and which will not be barred by the reasoning underpinning *Fairfield Sentry*. One example is claims based upon an allegation that the redemption payment was void as an unauthorised return of capital. In general offshore jurisdictions have specific statutory provisions which allow for payments of redemption funds out of capital which are tailored for the needs of investment funds. The basis upon which an unauthorised payment out of capital claim could be put will vary from jurisdiction to jurisdiction depending upon the relevant statutory provisions. Most statutory regimes allow for a payment to be made out of capital by way of redemption provided that such a payment is authorised by the articles. A fund, by its directors, must strictly comply with authorisation provisions. If these provisions have not been complied with the fund will have a claim for money had and received against the redeemers.

But that is not all. Since the payment will be made in breach of fiduciary duties, the fund will have the additional option of asserting constructive trust claims alleging the redeemers' unconscionable receipt of the company's funds with the additional proprietary rights which can be asserted and the prospect of sidestepping the redeemers' plea of change of position.

The company and insolvency law of each jurisdiction may provide even further assistance to liquidators. It is worth noting that there have not been any significant clawback rulings from the Grand Court of the Cayman Islands arising from the 2008 downturn. Since Cayman has by far the most hedge funds this may be surprising. A review of specific statutory provisions indicates that Cayman may be one of the more favourable jurisdictions for clawback claimants.

Section 37(6) of the Companies Law (2011 Revision) specifically provides that a share redemption payment "is not lawful unless immediately following the date on which the payment out of capital is proposed to be made the company shall be able to pay its debts as they fall due in the ordinary course of business". Given the strict approach in law to payments out of capital this subsection could provide a powerful recovery tool for liquidators, particularly as it has been confirmed that outstanding payments due to other redeemers are a debt of a fund. This statutory provision offers real prospects of forming the springboard for claims involving funds which entered into a period of "fire-fighting" with third party creditors or with redeemers prior to any liquidation. Redeemers who received payments when other redeemers went unpaid will be at considerable risk. Side-letter arrangements which were not tracked in the Articles may also warrant close scrutiny. Statutory provisions which seek to limit the impact of *ultra vires* payments, such as s 28 of the Cayman Companies Law, should not affect legal relationships between those privy to the Articles of Association.

Furthermore, Cayman liquidators are expressly obliged to rectify the share register of a fund and to restate NAV under Order 12 of the Companies Winding-Up Rules 2008 and s 112 of the Companies Law provided that certain criteria are satisfied (primarily that there has been fraud or default). This obligation has significant impact upon how clawback claims may be determined in a Cayman liquidation. The process envisaged by the winding up rules would mean that when the Order 12 process is engaged liquidators will identify the parties who were overpaid and quantify any overpayment, and may have the effect of reversing the burden upon redeemers to issue court proceedings challenging the restatement and rectification process.

WHAT NEXT FOR CLAWBACK CLAIMS?

This brief review of different means of formulating clawback claims should indicate that *Fairfield Sentry* is the beginning, not the end, of a process of resolving the many potential clawback pending in the offshore world.

The facts of *Fairfield Sentry* were favourable towards the redeemers, with the potential exception of the allegations that the underlying NAV was in fact close to nil value. There remain many potential claims which involve significantly different factual and legal matrices. As a general rule of thumb, claims which relate to redemptions made towards the end of a fund's active life should have the best prospects of success for liquidators, particularly if the fund or specific asset classes held by the fund exhibited stress at the time of the redemption payment so as to put redeemers on notice of those problems.

Fairfield Sentry will no doubt be relied upon by redeemers as part of a general argument that the law of restitution will not allow recovery absent specific identifiable fault on the part of the redeemer. How the Good Consideration Issue will play out when there is a formally restated NAV or in claims based upon allegations that the payment by the fund was an *ultra vires* payment out of capital will provide some of the most interesting and challenging legal battlefields in offshore litigation in the coming years. ■