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How investors get their money back

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An increasing number of the unlucky investors caught up in suspended or failing investment vehicles are wondering how they will fare in the competition for assets that remain in the funds. In that competition investors would normally expect to be subordinated to creditors.

However, this means investors receive not merely less than the unsecured market counterparties, as would be expected, but, more surprisingly, also less than "redemption creditors". These are, after all, simply other investors like themselves who managed to lock into redemption rights early enough to become unsecured creditors before the gates came down and net asset values were corrected. A fund vehicle's liability to such redemption creditors on unadjusted historically inflated NAV calculations leaves less for those who get left behind.

There are a number of ways in which this distribution scenario can be disrupted. Exceptionally, it may be possible to adjust NAV calculations retrospectively and, when that can be done, it redresses the balance between past and present shareholders. Another way for investors to seek parity is to transform their status to that of creditor. Creditors are entitled to share distributions pari passu (ie pro rata according to their claims). By becoming creditors, investors gain the ability to compete in the pool of unsecured creditors with those former investors.

By formulating an unliquidated claim for damages against the investment vehicle itself, the investors could achieve just that. One type of claim might be based on the fund's failure to adhere to an agreed investment strategy. The difficulty there is in establishing sufficient loss to improve the investors' position in their competition with redemption creditors. In that respect more fertile grounds for claims would be misrepresentations in offering memoranda or other promotional material. Assuming all legal elements of a claim for misrepresentation can be established, in some circumstances investors could seek to recover their entire investment by way of claims for damages. At least that should put them on a more level playing field.

In the UK and offshore jurisdictions (where many of the relevant liquidations take place) it is unclear whether misrepresentation claims rank alongside other unsecured creditors. There is no point in making these claims if investors are demoted in the distribution battle below redemption creditors, entitled only to what they would receive as shareholders anyway. It is therefore important for investors to ensure there is parity between the misrepresentation and redemption claims.

Historically, by virtue of statutory provisions dating back to 1862 and 19th century case law, it has been assumed that investors' claims for misrepresentation in promotional material cannot be asserted as creditor claims against the fund company. Those claims can be asserted against third parties but they assume a hybrid status in the liquidation of the company itself, ranking below other creditors, although still above ordinary equity. This was true of the UK and most other jurisdictions with a common law tradition. In the US, the mandatory subordination of shareholder claims by section 510(b) of the US Bankruptcy Code is much clearer.

However, there seem to be two potential solutions. A recent case in the High Court of Australia may have opened the door for a reconsideration of these principles. It is distinctly possible that the 19th century rule will not be followed in the offshore jurisdictions. Even if the old case law stands, the principle could also be applied to

redemption creditors. Investors could argue that redemption creditors should be subordinated below unsecured creditors and alongside the misrepresentation claims. It is less clear that the old case law ever applied to redemption claims. This point remains effectively undecided.

Another tactic for disturbing the classic distribution scenario is for investors to try to force a shift of the assets within a group of fund companies, thus questioning whether creditors of a particular sub-fund or company are justified in treating all the assets in that entity as their own.

Improving an investor's position in a failed fund will be challenging because the arguments to be deployed are complex and sometimes novel. As this is uncharted territory there is little in the way of precedent and no text book which points to the answers. However, that is where there is presently an opportunity for investors to negotiate themselves into a better position.

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