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IN THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION
The Hon. Mr Justice Andrew J. Jones QC
Tuesday 19th January 2009 2010

CAUSE NO. FSD 15 of 2009 (AJJ)

IN THE MATTER OF SECTION 92 OF THE COMPANIES LAW (2009 REVISION)

AND IN THE MATTER OF BELMONT ASSET BASED LENDING LTD

Appearances: Mr Simon Dickson of Mourant du Feu & Jeune for the Petitioner
Mr Sam Dawson of Solomon Harris for the Fund

JUDGMENT

1. This is a petition presented pursuant to section 94(e) of the Companies Law (2009 Revision) for an order that Belmont Asset Based Lending Ltd ("the Fund") be wound up compulsorily and that Messrs Wight and Sybersma of Deloitte be appointed as joint official liquidators.

FACTUAL BACKGROUND

2. The Fund was incorporated on 24th October 2003 as an open ended investment fund and was registered with the Cayman Islands Monetary Authority pursuant to section 4(3)(c) of the Mutual Funds Law. It was promoted by Harcourt Investment Consulting AG ("Harcourt") which is part of the Vontobel Banking Group, headquartered in Zurich, Switzerland. Harcourt acts as the Fund's investment adviser and Alternative Investment Solutions Limited, a wholly owned subsidiary of Harcourt, acts as its investment manager. The Fund's board of directors comprises three individuals who are all employees either of Harcourt or other Vontobel group companies. A nominal 100 voting shares have been issued to the Investment Manager. The Fund's investors have subscribed for redeemable

participating shares which do not carry any voting rights. The result of this structure is that the Fund is wholly controlled by Harcourt. The holders of the redeemable participating shares, who own the whole economic interest in the Fund, are not entitled to requisition an extraordinary general meeting for the purposes of passing a special resolution to put the Fund into voluntary litigation. Only Harcourt has power to put the Fund into voluntary liquidation, but it has declined to do so for reasons which have not been explained to the Court.

3. The Fund's administrator is Citco Fund Services (Europe) BV, which is wholly independent of the Vontobel group. Its custodian and bankers are also members of the Citco group. The Administrator does not now have any representation on the Fund's board of directors.

4. The Petitioner is Bear Sterns Alternative Assets International Ltd ("Bear Sterns") which operated as a division of the Bear Sterns investment bank and is now part of the JP Morgan Chase Group. Bear Sterns is registered as owner of approximately 1.18 million redeemable participating shares in the Fund which were valued at approximately $104 million, based upon the NAV figures issued by the Fund for 30th September 2008. On 19th September Bear Sterns submitted a redemption request in respect of that number of shares which would have a value of $8,800,000 as at 30th September 2008.

5. The investment objective of the Fund, as stated in Section 3 of its offering document (entitled *Confidential Information Memorandum*), is to provide long term capital appreciation to shareholders by investing in a diversified portfolio of asset-based lending and related strategies. As a result of events occurring in September 2008 it is accepted by all those involved in the management of the Fund that it is no longer in a position to pursue its investment objective and that is not now viable as a mutual fund. This situation came about as a result of two factors, namely the general market conditions which caused a severe credit crunch and the effects of a fraud committed by Mr Tom Petters. Allegations of fraud against him were first made public in September 2008 and he has recently been convicted by a US District Court in Minnesota of carrying out what was described as a "multi billion dollar Ponzi scheme". The value of various investments made by the Fund in entities which were managed by or related in some way to Petters Company Inc have been written off or substantially written down in value. Harcourt concluded that investments in Lancelot Investors Fund Ltd and Palm Beach Offshore II (which represented 14.57% of the Fund's recorded assets) should be written off. An investment in Stewardship Credit Arbitrage Fund (representing 4.79% of the Fund's recorded assets) was written down by 61% and investments in other funds (representing 7.9% of its recorded assets) became unrealisable because those funds suspended redemptions.

6. The combination of the credit crunch and the Petters fraud had a serious adverse impact upon the Fund. As a consequence, on 27th October 2008 the Fund's board of directors passed a series of written resolutions by which they (a) recommended that the Investment Manager (as owner of the voting shares) pass a special resolution placing the Fund into voluntary liquidation and (b) declared a suspension of the calculation of NAV and consequential suspension of redemptions and subscriptions. The copy of these written resolutions exhibited (at page148) to Mr Edouard Tijou's affidavit is signed by only one of the three directors, but I was told by counsel that duplicates of the resolutions were in fact signed by all three directors. On 31st October the Fund's Administrator sent a circular letter to the shareholders informing them of the Board's decision. The Administrator stated "the Directors have deemed that the continued operation of the [Fund] is no longer viable and that steps should be taken to realise the [Fund's] portfolio and to place [the Fund] into voluntary liquidation". Since two of these directors are themselves employees of Harcourt and the third is an employee of another Vontobel group company, the shareholders were entitled to assume that the directors' recommendations were in reality decisions which would be implemented immediately.

7. For reasons which have not been explained, Harcourt changed its mind and has not in fact taken the steps necessary to put the Fund into voluntary liquidation pursuant to the Companies Law. Instead, Harcourt set about the task of realising the assets and making distributions to shareholders without having put the Fund into liquidation and appointing a liquidator. Bear Sterns become dissatisfied with the way in which the informal liquidation process was being conducted and on 26th November 2009 presented a petition for an order the Fund be wound up compulsorily by order of the Court and that qualified insolvency practitioners be appointed as official liquidators. It is not in dispute that the Fund is solvent on a balance sheet test. Nor is it in dispute that the Fund is no longer viable as a mutual fund.

BEAR STEARN'S WINDING UP PETITION

8. By its petition Bear Stearns contended that the Fund should be wound up on the "just and equitable" ground for three reasons, namely that (a) having suspended NAV, the Fund's management were acting in a manner which was contrary to its articles of association and therefore in breach of the legal bargain between the company and its shareholders; (b) Harcourt is acting in breach of duty and has lost the confidence of shareholders; and (c) there has been a "loss of substratum", meaning that the purpose for which the Fund was established can no longer be carried out and that it has ceased to be viable as a mutual fund.

9. The Petition was listed for directions on 18th December 2009 in accordance CWR Order 3, rule 11. Having determined that the Petition should be treated as a proceeding *against* the Fund, as opposed to treating it as a proceeding between shareholders in which the Fund itself is merely the subject-matter of the proceeding, I directed that one of the Fund's directors, Mrs Margaret Thompson, should send to every other shareholder and every known creditor copies of the winding up petition, the verifying affidavit, the supporting affidavits sworn by the qualified insolvency practitioners nominated for appointment as official liquidators and any explanatory statement made by Harcourt. Given that the petition contained allegations of breach of duty against Harcourt, this was the classic case in which the independent directors should have determined the Fund's response to the winding up petition in the interests of its investors. It is established best practice for mutual funds incorporated in the Cayman Islands to have a board of directors which includes at least some persons, if not a majority, who are independent of the investment manager and administrator. In this case the Fund has no independent directors at all. Two out of three members of the board are employees of Harcourt and the third, Mrs Margaret Thompson, cannot be regarded as independent because she is an employee of Vontobel Bank Cayman Ltd which is a wholly owned subsidiary of the same group as Harcourt. Why Harcourt failed to comply with industry standards in this respect was not explained. The task of communicating with the shareholders and making a recommendation about the merits of the petition therefore fell upon Mrs Thompson on the basis that she was *relatively* independent in that she was not employed by Harcourt and the allegations of breach of duty were not made against her directly.

10. On 4th January 2010 Mrs Thompson duly sent the petition and other documents to all shareholders and known creditors, together with a covering letter in which she refuted the first two grounds asserted in the petition, but accepted that there has been a "loss of substratum". She advised that the Board of Directors would not oppose the petition on behalf of the Fund and recommended that the other shareholders should not oppose it. In the event, no shareholders gave notice of intention to oppose (or support) the petition and it came on for hearing unopposed. Counsel for Bear Stearns informed me that his client had agreed to withdraw the first two grounds (set out in paragraphs 45-65 of the petition) and argued that it was "just and equitable" for a winding up order to be made solely on the ground that the Fund has suffered a "loss of substratum" and ceased to be viable as a mutual fund. I made an order allowing the petition to be amended by deleting paragraphs 45-65. On this basis the Fund's directors did not oppose the making of a winding up order.

11. A winding up order is a discretionary remedy. By issuing a winding up petition the shareholder or creditor is invoking class rights, with the result that all those in the class are entitled to be heard, for which purpose winding up petitions are normally required to be advertised. A winding up order is "binding upon all the world". It takes effect for the benefit of and is binding upon all shareholders and creditors (including contingent creditors and claimants), whether or not they have had actual notice of the petition. It follows that it is not open to a petitioner and the company (acting by its board of directors) to ask the Court to make a winding up order "by consent". Notwithstanding the agreement between the Fund and Bear Stearns, I must still satisfy myself that this is a proper case in which to make a winding up order on the basis of the facts pleaded in the petition, as now amended.

THE JUST AND EQUITABLE GROUND

12. The issue is whether a finding of "loss of substratum" is, by itself, sufficient to justify the Court in making a winding up order on the just and equitable ground under section 94(e) of the Companies Law (2009 Revision).

13. The expressions "loss of substratum" or "failure of substratum" are derived from English case law dating back to a decision of the Court of Appeal in *Re Suburban Hotel Co* (1867) L.R. 2 Ch. App. 737 at 750. Whilst it may be helpful for the Court to categorise circumstances in which it will be considered just and equitable for a company to be compulsorily wound up, I question whether it is sensible to adopt terminology invented in the context of England's nineteenth century economy. A company was said to have "lost its substratum" if the purpose for which it was formed can no longer be carried out (per Kekewich J. in *Re Bristol Joint Stock Bank* (1890) 44 Ch.D a703 at 712); or if the company has practically ceased to carry on business because it has become impractical to do so (per James LJ in *Re Diamond Fuel Co* (1879) 13 Ch.D 400, at 408); or if the company was formed to pursue a specific business opportunity which is no longer available to it (*Re Haven Gold Mining Co.* (1882) 20 Ch.D 151). To translate these statements into a modern context, it can be said that it is just and equitable to make a winding up order in respect of an open ended corporate mutual fund if the circumstances are such that it has become impractical, if not actually impossible, to carry on its investment business in accordance with the reasonable expectations of its participating shareholders, based upon representations contained in its offering document. If such a company, organised as an open ended mutual fund, has ceased to be viable for whatever reason, the Court will draw the inference that it is just and equitable for a winding up order to be made.

14. This principle has been applied most recently by this Court in *Re Philadelphia Alternative Asset Fund Limited* (Cause 440/2005). This case concerned a solvent company which had ceased to be viable as an open ended mutual fund because its management had fraudulently overstated its NAV and a US District Court had appointed a receiver on the application of the Commodity Futures Trading Commission. Henderson J. said "In cases where the substratum of a company is gone, winding up will usually be ordered despite the opposition of even a majority of members". A winding up order was made.

15. The Supreme Court of Bermuda has recently adopted exactly the same approach in applying a similar "just and equitable" provision contained in the Bermuda Companies Act, 1981 which has essentially the same legislative history as the equivalent Cayman Islands provision. In *Re Stewardship Credit Arbitrage Fund Ltd* (2008: No.2006) the court was asked to make a provisional winding up order in respect of an open ended mutual fund which, as it happens, was also a victim of the Petters fraud. It is actually one of the companies in which the Fund invested. Bell J. said " ..the critical complaint to my mind is ... that the substratum of the Company has gone. From the time of the 9th June directors' meeting, the Company has effectively ceased to carry on business, and in practical terms, I have no doubt that the prospect of its carrying on its business in any real way in future has long since disappeared". A provisional winding up order was made.

16. Wherever it is proved that a company established as an open ended mutual fund is no longer viable as such, for whatever reason, the Court will ordinarily conclude that it is just and equitable to make a winding up order. This situation may come about for any number of reasons and not necessarily as a result of any breach of duty, negligence or even bad judgment on the part of the fund's investment managers or administrators. In the present case, the Fund's inability to meet redemption requests and the sudden collapse of its NAV occurred in September and October 2008 as a result of the combined effects of the Petters fraud and an unprecedented credit crunch. There is no suggestion that the Fund's difficulties were caused by any fault on the part of Harcourt. The allegations made against Harcourt (and now withdrawn) related to their attempts to liquidate the Fund following suspension of NAV, not the manner in which they had invested and managed the Fund's assets prior to the events of September 2008. There are sound policy reasons for making a winding up order in respect of non-viable mutual funds, in spite of the fact that this situation has arisen without fault on the part of its management.

17. Typically, mutual funds are established in the Cayman Islands by foreign financial services companies which then act as investment manager or adviser pursuant to a contract, the terms of which will be summarised in the offering document. The skill set required of a

successful investment manager is wholly different from that required of professional liquidators. Investment management agreements are invariably made on the assumption that the fund is a going concern and that the investment manager will be responsible for making investment decisions and managing investments, with the result that its terms may be inappropriate to the situation in which the fund is being liquidated. Typically, the investment managers are remunerated on the basis of a percentage of NAV, often coupled with performance fees calculated as a percentage of realised gains. This basis of remuneration will become inappropriate if the fund ceases to be viable and the investment manager ceases to perform at least some of the functions contemplated by the investment management agreement and instead attempts to adopt a liquidation role. Investment management agreements rarely, if ever, contemplate the scenario in which the service provider's role changes from that of investment manager into that of liquidator.

18. An investor's decision to subscribe for shares will be based upon the reputation and past performance of the investment manager. So long as a fund's assets are being invested and managed in accordance with investment criteria and guidelines set out in the offering documents, shareholders cannot and do not expect to have any say in the investment decisions. The position changes if the fund ceases to be viable with the result that the calculation of NAV is suspended and the principal or only function left for management is to realise the assets for the benefit of creditors and shareholders. This exercise may involve an investigation and pursuit of claims against the investment manager and other professional services providers which can only be undertaken by profession independent liquidators. Even if a fund is solvent on a balance sheet test and there is no apparent cause of complaint against any of its service providers, its investors should still not be deprived of the advantages of having the task performed by professional independent liquidators. Nor should they be deprived of the protections provided by the Companies Winding Up Rules, simply because the investment manager (who may not have been at fault) chooses to undertake the task itself.

CONCLUSION

19. For these reasons I am satisfied that it is just and equitable to make a winding up order in respect of the Fund simply on the basis that it is no longer viable as an open ended mutual fund and notwithstanding that the allegations of breach of duty made against its investment manager have been withdrawn.

20. I am satisfied that Messrs Wight and Sybersma, partners in the Cayman Islands firm of Deloitte, are qualified insolvency practitioners who meet the requirements of the Insolvency

Practitioners' Regulations in relation to the Fund. I therefore make an order that they be appointed joint official liquidators.

21. Since there never was any allegation of incompetence, negligence or bad judgment against Harcourt in respect of their management of the Fund's assets prior to the events of September 2008 and the allegations made in respect of their attempts to liquidate the Fund have been withdrawn, I authorise the official liquidators to engage the services of Harcourt as advisers if they consider it appropriate to do so.

22. Otherwise, I make a winding up order in the usual terms.

Dated 21st day of January 2010

The Hon Mr Justice Andrew J. Jones QC

GRAND COURT - CAYMAN ISLANDS