IN THE GRAND COURT OF THE CAYMAN ISLANDS
HOLDEN AT GEORGE TOWN, GRAND CAYMAN

CAUSE NO. 207 OF 2006

IN THE MATTER OF THE COMPANIES LAW (2004 REVISION)

AND IN THE MATTER OF SPHINX STRATEGY FUND LTD.

Appearances: Ms. Laura Hatfield and Ms. Wanda O'Connor of Solomon Harris for the Petitioners
Ms. Sandie Corbett and Mr. Nick Robinson of Walkers for the Company

Before: Hon. Justice Henderson

Heard: June 27, 2006

RULING

At the commencement of the hearing of this petition, I have entertained two preliminary arguments.

First is the petitioner a creditor within the meaning of the Cayman Islands Companies Law?

Second, was there material nondisclosure on an earlier *ex parte* application which should disentitle the petitioner to the relief it seeks now? I will address the issues in that order.

The petition addresses the question of standing in paragraphs 10 to 14 inclusive, which read:

> "The petitioner held 16,805.0597 class FT-3-H shares in the company, with an investment value of US $16,412,116.38. On or about 16th February 2006, the petitioner made written request for redemption of the FT-3-H shares, which redemption was processed on 28th February 2006, but no redemption proceeds have been received by the petitioner from the company for the redeemed FT-3-H shares. The petitioner held 22,026.4031 class FTX-3-BB shares in company, with an investment value of US $23,670,623.77. On or about 6th April 2006, the petitioner made written request for of all of the FTX-3-BB shares, which redemption was on 28th April 2006, but no redemption proceeds have been received by the petitioner from the company for the redeemed FTX-3-BB shares. The petitioner is a creditor of the company for not less than US $40,384,865.57, being the total outstanding of the redemption

> of the FT-3-H and FDX-3-BB shares."

The petitioner then pleads that the company is insolvent and is unable to pay its debts as they fall due, that certain information has been sought from the company but has not been given, and that there is no adequate remedy for the petitioner other than a winding up order.

I heard an *ex parte* application earlier in the month and, based upon the evidence of the petitioner and the argument then made, I appointed Mr. Varga as provisional liquidator. This was a creditors' petition. In accordance with what I apprehend to be the usual practice in the Cayman Islands, I did not seek from the petitioner any undertaking as to damages and none was offered.

The position has now been illuminated during the course of a one half-day *inter partes* hearing. It is now understood and accepted that a temporary restraining order was granted by the US Bankruptcy Court in New York in December of 2005. That had the effect of preventing the company from redeeming its shares in cash. However, under the terms of the offering memorandum and its own articles, the company also had the right to redeem shares by payment in kind.

The material part of the offering memorandum says (at page 30):

> "Redemption proceeds may be made (sic) in cash or in the sole discretion of the investment manager in consultation with the board in the form of securities having a market value equal to the amount due or partly in cash and partly in securities. Any such securities to be distributed to an investor will be by the investment manager in its reasonable discretion. Any such distributions will not materially prejudice the interests of remaining shareholders."

Certain documentation was issued by the company to advise this investor (perhaps I should say "attempt to advise this investor") that the redemption would be in kind and not in cash.

A final confirmation of redemption, dated April 5th 2006, was addressed to Mr. Therrien (the Petitioner's deponent) and, if read carefully, might have warned him of a redemption in kind. The document, however, contains the wrong name of the investor and makes no clear statement of the form the redemption will take.

A second document (relating to the second tranche of shares to be redeemed) was issued May 24th 2006, addressed to Mr. Therrien. This "Preliminary Confirmation of Redemption" makes reference to "a wire transfer of 90 percent of the cash redemption proceeds to your financial institution as per your instructions" and likely perpetuated the misunderstanding.

The clearest indication that this was to be a redemption in kind is contained in a letter dated March 7th 2006 to the investors, including the petitioner. This letter would have been sent to Daiwa Europe Fund Managers (Ireland) Ltd., who had been contracted to manage certain of the petitioner's investments, including this one. Mr. Therrien has sworn that it never reached his desk. The letter reads in part:

> "As you can see from the accompanying confirmations, to the extent that any of your redemptions come directly or indirectly from SMFF ("SMFF Redemption"), proceeds of such redemptions are being paid to you in the form of shares (the "Special shares") which represent the underlying assets in SMFF, subject to the attachment order in the preference action. These provide the number and class of Special Situation shares you are receiving. While the Special Situation shares may be of a company different from the one in which you had invested, they track the portion of your investment directly or indirectly in SMFF."

1 Apparently the letter was never forwarded to Mr. Therrien.

2

3 Certain unaudited account statements were issued at month end by the company and addressed to

4 Mr. Therrien. These make reference to in kind share subscriptions. At least one of them

5 incorrectly states the name of the fund.

6

7 I have before me now certain pages from the register of members of the company which appear to

8 confirm that the shares have been redeemed by the transfer of other shares; that is to say, a

9 redemption in kind.

10

11 It is now conceded by the petitioner that:

12 A) the company had the right to redeem in kind by paying
13 the petitioner in marketable shares of equivalent value instead
14 of cash;
15 B) that is what the company has purported to do; and,
16 C) it was obliged to proceed in that manner because of the
17 temporary restraining order.
18

19 The petitioner says, however, that the obligation of the company is to provide marketable shares of

20 equal value, and it has not done so. Not having done so, the petitioner is a creditor.

21

22 The first question is whether I have adequate evidence of a decision by the investment manager and

23 the board of directors to redeem for in-kind shares instead of cash. The only evidence of an

24 appropriate directors' resolution is found in paragraph nine of Mr. Feireghy's first affidavit where

25 he says "it was resolved" that an in kind redemption should be made. He does not say who

1 resolved to do that. He makes no mention of the investment manager. He does not say there was a
2 directors' meeting on the subject. No directors' resolution is attached to his affidavit.
3
4 Ms. Corbett has asserted that such a resolution was passed and has undertaken to file a
5 supplementary affidavit attaching one. I accept that offer and will rely upon it. On that basis, the
6 weight of the evidence satisfies me that certain in-kind shares have been transferred to this
7 petitioner to settle the redemption obligation.
8
9 Did those shares have a market value equal to the amount due?
10
11 The company says they did. In support of that assertion, it points to its own NAV calculations.
12 That amounts to little more than a demonstration that the company believes the shares to be of
13 equal value.
14
15 The petitioner says the shares are likely to prove to be of much less value than the redeemed
16 shareholding. In demonstration of that, it points to a claim advanced by the company for US $312
17 million in litigation in New York which has recently been settled for US $49 million. There is no
18 evidence before me of the other assets of the company or of the other claims of creditors and
19 redeeming investors. A director of the company has sworn that it is solvent.
20
21 On the question of standing, the burden is on the petitioner to show on the balance of probabilities
22 a good arguable case that it is a creditor or a contributory. I would need evidence (probably in the
23 form of expert opinion evidence) before I could conclude that the in-kind shares are not of equal

value. On the current state of the evidence, that proposition remains firmly in the realm of speculation. The petitioner has failed to establish that it is today, or was as at the date of the petition, a creditor. It lacks standing. Therefore, the petition is dismissed.

I turn to the question of the *ex parte* order.

Having granted the *ex parte* order, I installed Mr. Varga as provisional liquidator. He has made certain enquiries and has undoubtedly incurred some cost. I have set aside the petition on the ground that the petitioner does not have standing to advance its claim. How did the Court come to find itself in this position?

The fact that it was to be an in-kind redemption is most certainly a material fact, as is the fact that redemption shares have now been issued to the petitioner. These facts were neither pleaded nor disclosed.

The evidence does not permit an inference that this material nondisclosure occurred deliberately. The petitioner, as I have said, employed Daiwa Europe to manage its investment. Certain critical documentation, including the March 7th letter, appears not to have been forwarded by Daiwa to its client. E-mail messages sent to two of the petitioner's employees asserted that there would be a redemption in kind. The significance of these appears not to have been understood and appreciated. They were not forwarded to Mr. Therrien.

1 In my view, the petitioner could have determined, through reasonable effort, that the company
2 proposed to effect a redemption in kind. I consider that the material nondisclosure on the *ex parte*
3 application came about because of insufficient diligence by the petitioner when preparing its
4 application. Had I not reached the conclusion that the petition itself must be dismissed, I would
5 have discharged the *ex parte* order now on the ground of material nondisclosure alone.
6
7 This, it seems to me, is a cautionary tale for attorneys practising in this jurisdiction (several of
8 whom are present in the courtroom). Lawyers depend on clients for their instructions as to the facts.
9 Clients depend on lawyers for an appreciation of the disclosure obligation and the need to be
10 diligent in ensuring full disclosure to the Court. Since clients do not always take their disclosure
11 obligation as seriously as they should, lawyers must give considerable thought to the risks of an *ex*
12 *parte* application before making one. Should it be made at all? Might an *inter partes* application
13 be safer, in the sense that material nondisclosure will not attract the same draconian consequences
14 on an *inter partes* hearing?
15
16 There was a single phrase in a single e-mail message before me on the *ex parte* application which,
17 if its significance had been appreciated, might have led to a train of enquiry about a redemption in
18 kind. It was never mentioned during that application. I assume that counsel who obtained the
19 *ex parte* order was as unaware of its significance as I was.
20
21 The obligation of a party on an *ex parte* application is to make full disclosure of all material facts.
22 However, the obligation of counsel goes further. He must bring to the Court's attention any
23 argument of substance or any legal authority which tells against his position. Disclosure means

more, much more, than simply filing the relevant documents. The Court's attention must be drawn to their significance and to possible arguments which the absent respondent could advance if it had been present. If counsel is uncertain of his or her ability to accomplish this, or of the client's willingness to allow counsel to do so, then an *inter partes* hearing is a safer and more appropriate course.

Dated this 27th day of June, 2006

Henderson, J.
Judge of the Grand Court