CHANGING THE TERMS OF A FUND OFFERING UNDER CAYMAN ISLANDS LAW

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It is often necessary after the launch of a fund that certain of the terms made in the initial offering need to be varied. The way that these changes are made to the offering terms are not always straightforward and require careful analysis. The type of consent that is required from investors will depend on the document which is being varied and whether such document anticipates the changes being made and whether they were drafted to pre-empt investor consent issues.

WHAT CHANGES REQUIRE CONSENT?

Not all changes require consent of course. A simple update to a disclosure in relation to the service providers, for example, or an amendment to incorporate changes to the law would generally not be sufficiently material to alter the terms with the underlying investor. However, more commonly we see changes made to the investment strategy, the investment objectives, variations to the liquidity terms (for example, changes to the notice periods, redemption days or amendments to the lock-in periods), or even in some cases the change of the investment manager. There is no definitive list of changes which require consent and it is often a question of degree, taking account of particular investor expectations or considering the impact of all the changes as a whole on a particular investor.

It is often assumed that a relaxation in the liquidity terms would benefit the investors and not require consent. That is not always the case and consideration should be given as to whether an investor may be disadvantaged by his fellow investors being permitted to redeem out more easily than was envisaged at the launch of the fund.

Principally, there are two sets of documents which govern the relationship between the investor and the fund; the first being the subscription agreement which incorporates by reference the offering document and, secondly, the constitutional documents of the fund being, in the case of a company, the Memorandum and Articles of Association.

THE SUBSCRIPTION AGREEMENT AND OFFERING DOCUMENT

The contract formed by the subscription agreement constitutes a separate agreement between the fund and each investor; this can be considered the "economic contract".

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A basic principle of contract law is of course that any amendment to a contract requires the consent of all the parties to the contract. In the case of the contract formed by the subscription agreement, there are in fact a series of separate contracts between each investor and the fund. Therefore, whilst one investor may have consented to a material change to the terms of the offering, another investor who has not consented may have a claim for breach of contract.

Investor consent may be obtained expressly by the investor signing a letter acknowledging the changes and the receipt of the updated offering document or supplement.

It is, however, often difficult to get unanimous consent from the investors and it may be necessary to explore the option of negative consent. This involves providing the investors with a notice of the proposed changes and giving them an opportunity to redeem out of the fund without penalty prior to the changes being effective. Although this is a unilateral amendment (and consent of all parties has not been obtained in accordance with basic principles of contract set out above), the parties do have an obligation to mitigate their loss which they can do by exercising their right of redemption.

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When drafting the offering document, express provisions can be included setting out how variations may be implemented. This may include a right to unilaterally amend the offering document provided those changes do notmaterially adversely affect the investors. The offering document can go further and provide that material changes can be made to the offering provided the investors are informed of the changes prior to them being implemented and giving them the opportunity to redeem out of the fund without penalty. In this way the negative consent concept is expressly built into the offering document so that it can be relied on without risk of a breach of contract.

THE ARTICLES OF ASSOCIATION

Other investor consent requirements derive from Cayman Islands corporate law and from the Articles of Association of the fund.

Typically, the Articles of Association are drafted in broader terms referring instead to the detail set out in the offering document. This means that often amending the Articles is not required. Where an amendment is required, a special resolution of the voting shareholders would be necessary to effect such changes. Where non-voting shares have been issued to the investors, the manager often holds the voting shares and is able to pass such a special resolution by itself. Where voting shares are issued to investors, however, a meeting of the shareholders may be required or alternatively the fund may obtain a unanimous written resolution of all of the shareholders.

Where there is a proposed modification of the rights attached to a particular class of shares then the Articles of Association typically prescribe how such changes may be implemented. Class rights are quite narrowly defined and include the right to a dividend, the right to vote and the right to receive capital on a winding up.

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There are certain steps that can be taken in the initial drafting of the Articles of Association to facilitate changes. For example, providing some flexibility to allow the directors to exercise their discretion to deviate to a degree. The directors must of course still be mindful of acting in the best interests of the fund when exercising those discretions. Issuing voting management shares to the investment manager will facilitate amendments to the Articles but, if voting shares are issued to the investors, the subscription agreements could include a standing proxy allowing a service provider to exercise the shareholder's vote on behalf of the investor.

CREATION OF A NEW CLASS

Often a fund agrees to vary the investors' liquidity rights in a side letter. Side letters present their own considerations but the fund should be mindful that, where terms are varied in this regard with one but not all of the investors in a class, they may inadvertently create a new class of shares or subclass of shares by varying the rights with one investor.

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Chris Humphries is the managing director and one of the founding directors of Stuarts Walker Hersant Humphries. He is a recognised leader in his field by Chambers & Partners and Legal 500. He has registered several hundred mutual funds with the Cayman Islands Monetary Authority and frequently advises on regulatory and compliance issues involving funds, investment managers and fund administrators.