

Primeo v Herald: Clarifying the Rights of Redeemed Investors

The recent decision of Jones J in *Primeo Fund (in official liquidation) v Herald Fund SPC (in official liquidation)*^[1] addresses two matters of importance for investors in Cayman Islands' investment funds and Cayman Islands' insolvency practitioners:

(1) the effect of Section 37(7) of the Companies Law (2013 Revision) (the "**Law**") on the rights of redemption creditors; and (2) whether, and if so when, a liquidator must or may rectify the register of members of a fund in respect of which the net asset value ("**NAV**") has been mis-stated.

Background

The relevant factual background to the case can be briefly summarised as follows: Herald Fund SPC ("**Herald**") had been incorporated as an open ended investment fund in March 2004, and had originally invested substantially all of its assets in Bernard L Madoff Investment Securities LLC. In turn, the Primeo Fund ("**Primeo**") had, from 2004 onwards, invested substantially all of its assets in Herald. Accordingly, both Herald and Primeo were direct or indirect victims of the Madoff Ponzi scheme, which came to light on 11 December 2008.

Primeo was one of several investors which had submitted redemption requests to Herald for a redemption date of 1 December 2008 (the "**December Redeemers**"). Substantially all of these redemption requests were accepted by Herald and, on 1 December 2008, all of the December Redeemers' shares were removed from Herald's share register. Save for one investor, however, none of the December Redeemers were paid their redemption proceeds before Herald went into liquidation on 23 July 2013.

In *Herald*, the Grand Court (the "**Court**") was concerned with two issues:

1. whether Section 37(7) of the Law applied in respect of the shares which were subject to unpaid redemption requests submitted by the December Redeemers; and
2. whether/when a liquidator is obliged and/or entitled to rectify a company's register of members where the company's NAV has been mis-stated.

The Section 37(7) issue

Section 37 of the Law provides a statutory framework relating to the redemption and issue of a company's shares (and the purchase by a company of its own shares); section 37(7), which governs the redemption of a company's shares when that company is in liquidation, is of particular interest to Cayman Islands' insolvency practitioners

but, somewhat surprisingly, has never previously been considered in any substantive detail by the Court.

Section 37(7)(a) of the Law provides as follows:

“Where a company is being wound up and, at the commencement of the winding up, any of its shares which are or are liable to be redeemed have not been redeemed or which the company has agreed to purchase have not been purchased, the terms of redemption or purchase may be enforced against the company, and when shares are redeemed or purchased under this subsection they shall be treated as cancelled:

Provided that this paragraph shall not apply if-

(i) the terms of redemption or purchase provided for the redemption or purchase to take place at a date later than the date of the commencement of the winding up; or

(ii) during the period beginning with the date on which the redemption or purchase was to have taken place and ending with the commencement of the winding up the company could not, at any time, have lawfully made a distribution equal in value to the price at which the shares were to have been redeemed or purchased.”

Section 37(7)(b) of the Law provides that any payments due to shareholders pursuant to section 37(7)(a) shall rank behind unsecured creditors of the company, but ahead of ordinary shareholders of the company, thereby creating a three tiered system of priority in relation to the company’s stakeholders.

The Privy Council’s decision in *Strategic Turnaround*^[2] laid to rest the controversial notion of an ongoing “redemption process” and confirmed, as a matter of law, that an investor’s right of redemption (and a company’s right to suspend redemptions) is governed by, and must be determined by reference to, a company’s articles of association. Notwithstanding the authoritative guidance provided by *Strategic Turnaround*, there remained some uncertainty as to whether section 37(7)(a) (a sub-section which was not considered by the Privy Council) affected the rights of investors who had redeemed prior to a liquidation but had not been paid their redemption proceeds as at the commencement of the winding-up.

In light of the decision in *Strategic Turnaround*, it was accepted by all of the parties in *Herald* that the December Redeemers’ shares had been redeemed on 1 December 2008. The question that concerned the Court was therefore whether (as was contended by Herald) the fact that the December Redeemers had not received the proceeds of their redemptions meant that section 37(7) of the Law would nevertheless apply, with the effect that the December Redeemers’ claims for payment of their redemption proceeds would be subordinated to the claims of any unsecured creditors of Herald.

Jones J firmly rejected Herald’s argument, and found that section 37(7) has no application at all where shares have already been redeemed as at the commencement of a company’s liquidation.

Implications of the Section 37(7) issue

Subject to being overturned on appeal^[3], the decision in *Herald* means that section 37(7) is likely to become

largely irrelevant for liquidators of Cayman Islands' mutual funds[4]. If an investor has been redeemed as at the commencement of a fund's winding-up, but has not yet been paid the proceeds of his redemption, then he will be an unsecured creditor of the fund for those proceeds. Conversely, if redemption has not yet taken place as at the commencement of the winding-up then the investor will remain an unredeemed shareholder of the fund, due to the fact that section 37(7)(a) is statutorily disapplied in such circumstances[5].

It would appear that the only circumstances in which section 37(7) is likely to have any application going forward would be where a fund's articles of association require some positive step or steps to be taken by the fund in order to effect a redemption request which has been submitted by an investor, and where those steps have not been taken as at the commencement of the winding-up. In those specific circumstances, the shares which are subject to the redemption request could be said to be "*liable to be redeemed*" for the purpose of section 37(7)(a), thereby bringing that sub-section into effect.

However, we consider that the situation described above is unlikely to arise very often, if at all, given that the articles of almost all Cayman Islands' mutual funds do not require any positive steps to be taken by the fund in order to effect a redemption, but provide (for sound commercial reasons) that redemption will take place automatically on a specified date once a redemption request has been duly submitted.

Meanwhile, one practical consequence of this decision is that liquidators may need to reconsider their position in relation to redemption creditor claims which have been rejected on grounds relating to section 37(7), but where distributions are yet to be made.

The Rectification issue

As for the rectification issues, the Court had to determine two matters concerning the NAVs of the Herald fund in the period 2004-2008 (i.e. prior to the revelation of the Madoff fraud):

- (a) Whether the NAVs were not binding on Herald and its members by reason of "fraud or default", within the meaning of section 112 of the Law[6] and Order 12, rule 2 of the Companies Winding Up Rules ("**CWR**") [7]; and
- (b) Whether those same provisions applied so as to require or empower the Additional Liquidator of Herald to rectify Herald's register of members.

For these purposes, Primeo represented the class of investors arguing that the issues be answered in the negative (i.e. that the NAVs were binding and the register could not be rectified) whereas the Additional Liquidator represented those arguing the opposite.

In summary, Jones J reached the following conclusions:

- (a) As a matter of contract pursuant to Herald's articles of association, the NAVs remained binding between Herald and its members. They would only not be binding upon Herald and its members by virtue of "fraud or default" if such fraud or default could properly be imputed to Herald itself which had the effect of vitiating the contract with its members; for example, if Herald's directors had themselves acted with bad faith, but no such

allegation was being made;

(b) The Additional Liquidator therefore had no duty under CWR Order 12, rule 2 to rectify the register of members, because any such duty would only arise if the NAVs were not binding as a matter of contract;

(c) However, section 112 of the Law empowers the Court, though its Official Liquidator, to override the rights of the shareholders when necessary (for example, in the case of fraud committed by third parties which affects a company's NAV), in order to achieve substantial justice among them. The Additional Liquidator therefore had a *power* to rectify the register of members, in order to achieve justice as amongst those recorded as members *as at the commencement of Herald's liquidation*, irrespective of whether the NAVs were binding as a matter of contract. However, any rectification of the register would have no effect on investors who had already redeemed their shares as at the commencement of the winding-up, such as the December Redeemers; and

(d) Whether or not the Additional Liquidator should exercise that power (and, if so, how) is to be determined at the next hearing, in August 2015.

Implications of the Rectification issue

The practical consequence of Jones J's ruling is to leave untouched the rights of investors who redeemed prior to Herald's liquidation, but to permit the variation of rights as amongst those investors who remained as members at the commencement of the liquidation.

In reaching these conclusions, Jones J sought to reconcile these statutory provisions with the Privy Council decision in *Fairfield Sentry* – and so avoid the “commercially unacceptable” consequences that would result from redemptions having to be unwound as a result of re-stating the NAV – in a way that leaves open the prospect of doing greater justice as between those investors who remained members upon the company's liquidation.

Conclusion

The decision in *Herald* will be warmly welcomed by unpaid redemption creditors whose position has, absent any successful appeal, been significantly strengthened. The decision is less likely to be welcomed by other creditors of an insolvent fund (including, for example, unpaid service providers or judgment creditors), who are now likely to rank *pari passu* with the fund's unpaid redemption creditors.

[1] Unreported, dated 12 June 2015

[2] *Culross Global SPC Limited v Strategic Turnaround Partnership Limited* [2010] 2 CILR 364.

[3] As at the date of this article, the time for lodging an appeal has not yet expired.

[4] First instance decisions of the Court must be followed unless they are successfully appealed or unless another Judge at first instance is convinced that the original decision is wrong (see, for example, *Re BCCI (Overseas) Limited* [1994-94 CILR 56] and *Re Alibaba.com Limited* [2012 (1) CILR 272]).

[5] Pursuant to section 37(7)(a)(i) of the Law

[6] Section 112 Companies Law provides:

“1. The liquidator shall settle a list of contributories, if any, for which purpose he shall have power to adjust the rights of contributories amongst themselves.

In the case of a solvent liquidation of a company which has issued redeemable shares based upon its net asset value from time to time, the liquidator shall have power to settle and, if necessary rectify the company’s register of members, thereby adjusting the rights of members amongst themselves.

A contributory who is dissatisfied with the liquidator’s determination may appeal to the Court against such determination.”

[7] Order 12, rule 2 CWR provides:

“2. The official liquidator shall exercise his power to rectify the company’s register of members under section 112(2) if he is satisfied that:

(a) the company is or will become insolvent;

(b) the company has from time to time issued redeemable shares at prices based upon a mis-stated net asset value which is not binding upon the company and its members by reason of fraud or default, with the result that the company has issued an excessive or inadequate number of shares in consideration for the prices paid by one or more subscribers; and/or

(c) the company has redeemed shares at prices based upon a mis-stated net asset value which is not binding upon the company and its members by reason of fraud or default, with the result that the company has paid out excessive or inadequate amounts to former members in consideration for the redemption of their shares.”



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