

Herald –v– Primeo: How can Cayman Islands liquidators restate a fund’s fraudulently misstated NAV?

In the latest instalment in the ongoing litigation between *Herald and Primeo*,^[1] the Grand Court of the Cayman Islands has considered how liquidators of a Cayman fund may adjust the fund’s historic NAVs (and thereby alter the respective amounts to be distributed to the fund’s shareholders) in circumstances where those NAVs were misstated due to fraud or default and where calculating a “true” NAV for each subscription and redemption date would have been impractical or not cost effective. In this case, where the NAVs remained binding between Herald Fund SPC (“**Herald**”) and its shareholders as a matter of contract, the liquidators had a power (but not a duty) to restate Herald’s NAV and rectify its share register so as to accurately reflect the *relative* position of unredeemed shareholders. Since Herald’s NAVs were based entirely upon mis-statements by Madoff, in perpetuation of his massive fraud, the Judge held that this was the clearest case in which the power of restatement ought to be exercised.

Although United States Bankruptcy Courts have regularly grappled with such issues for years, this is, perhaps surprisingly, the first time that the problem has been addressed in any detail by a Cayman Court. The judgment will be of interest to Cayman Islands liquidators, and to investors in any Cayman funds which are wound up following either an “internal” fraud (within the fund) or, as in this case, an “external” fraud (within an entity in which the fund’s assets were invested).

Background

The background can be briefly summarised as follows. Herald had been incorporated as an open ended investment fund in March 2004, and had invested substantially all of its assets in Bernard L Madoff Investment Securities LLC (“**BLMIS**”). Primeo Fund (“**Primeo**”) had also invested substantially all of its assets directly in BLMIS until April 2007. At that time, Primeo made an *in specie* subscription for shares in Herald by assigning its entire shareholding in BLMIS (then valued at US\$465m) to Herald, in consideration for Herald issuing shares to Primeo. Following these transactions Primeo was, in effect, a feeder fund for Herald, and Herald was, in effect, a feeder fund for BLMIS, although both Herald and BLMIS had numerous other investors.

Accordingly, both Herald and Primeo were direct or indirect victims of the Madoff *Ponzi* scheme which came to light on 11 December 2008. It followed that, save for its very first fixed NAV of US\$1,000 / €1,000 per share applicable to initial subscribers, all of Herald’s historic NAVs based on which its investors (including Primeo) had subscribed for and redeemed their shares had been overstated as a result of Madoff’s fraud.

BLMIS was placed into bankruptcy in New York. The Bankruptcy Court addressed the impact of the fraud on

investors' claims into BLMIS by applying the "Net Investment Method"; that is, investors were only allowed to claim for the amount (if any) by which their gross subscription proceeds exceeded their gross redemption proceeds. Applying that method, the amount of Herald's claim into BLMIS was reduced from US\$1.9 billion (the amount shown on its final account statement) to US\$1.6 billion.^[2] Herald's US\$1.6 billion claim against BLMIS is currently estimated to be worth US\$750 million.

The businesses of Herald and Primeo collapsed overnight following the discovery of the Madoff fraud. Both entities were subsequently wound up in the Cayman Islands.

Decision

The issue before the Court on this particular application was whether, and if so how, Herald's additional liquidator should exercise his *statutory* power under section 112(2) of the Companies Law to rectify Herald's register of members (thereby restoring the register to a position reflecting the substitution of true NAVs for mis-stated NAVs), notwithstanding the Court's finding in an earlier judgment that Herald's NAVs were binding as a matter of *contract* between the company and its shareholders and could not be avoided on the grounds of an alleged mistake by the parties as to the true NAV.^[3]

The purpose and effect of section 112 of the Companies Law

The Judge found that the power conferred by section 112 of the Companies Law is in the nature of a class remedy; the concept of rectification of the share register "*implies restoring the register to the position which accurately reflects the relative position of the shareholders as it would be if all the relevant subscriptions and redemptions had been transacted as a true NAV*".

Should the share register be rectified?

As to whether the statutory power of rectification should be exercised, the Judge noted that this was not a case where a particular asset had been affected by fraud; this was a case where Herald's reported NAV had been "*driven by fraud from the inception of its business*" and where Herald itself had been nothing more than a feeder fund for a *Ponzi* scheme. In such circumstances, "*there could not be a clearer case in which the power ought to be exercised*", as failing to do so "*would result in giving effect to Madoff's fraud and enabling some shareholders to benefit from realizing fictitious profits at the expense of other shareholders*".

How should a rectification be undertaken?

As to how the power should be exercised, the Judge noted that the starting point was O.12, r.2(3) of the Companies Winding-up Rules 2008 (as amended) ("**CWR**"), which requires the liquidator to determine a true NAV as at each relevant subscription and redemption date. He found, however, that since BLMIS was a *Ponzi* scheme from inception, the nature of Herald's assets has been translated (as a matter of US law) from shares in BLMIS into a customer claim in the BLMIS bankruptcy calculated in accordance with the Net Investment Method. As such, Herald's true NAV, as of any particular subscription or redemption date, would be the *value* (as opposed to the *amount*) of Herald's customer claim in a hypothetical bankruptcy of BLMIS commenced on that date. Since this would be impossible to calculate (save perhaps with the help of the BLMIS trustee, which he noted was not forthcoming), the true NAV would have to be calculated in a manner which is "*both cost effective and fair and equitable as between the shareholders*", as provided for by CWR O.12, r.2(5) whenever it is

“*impractical or not cost effective*” to calculate the true NAV in accordance with CWR O.12, r.2(3).

Herald’s additional liquidator considered applying the Net Investment Method (under which the claim amount equals subscriptions less redemptions) and a variant, which he proposed should be adopted, called the “Rising Tide Method”. Under the Rising Tide Method, the distribution calculations would take further account of pre-liquidation redemption payments in a way which ensured that all shareholders ultimately received back the same percentage of their total capital invested. For example, if the total cash available for distribution in the liquidation equalled 50% of the total amount of capital invested by all shareholders, then (i) a shareholder who had received more than 50% of its total capital contribution through pre-liquidation redemption payments would receive nothing further from the liquidation, (ii) a shareholder who received pre-liquidation redemption payments equal to less than 50% of the capital it had invested would only receive a liquidation distribution of an amount which brought its aggregate return up to 50% of capital invested, and (iii) a shareholder who received no pre-liquidation redemption payments would receive a proportionally larger distribution from the liquidation in order to ensure that it too ultimately received 50% of its total capital invested.

Although the Judge agreed with the additional liquidator’s objective of trying to ensure a fair result, he concluded that the Net Investment Method and the Rising Tide Method both amounted to substituting a scheme of distribution which was different from the statutory order of priority mandated in liquidations by section 140 of the Companies Law, and that as such there was no jurisdiction under section 112 of the Companies Law, or CWR O.12, to impose either method on the shareholders.^[4]

The Judge concluded instead that the appropriate methodology was to treat Herald’s initial, fixed subscription price of US\$1,000 / €1,000 per share as being the “true” NAV for each and every subsequent subscription and redemption, which he noted would produce “*similar economic results*” to the Net Investment Method. He found that this approach was realistic (“*because it equates to the basis on which Herald’s claim in the BLMIS bankruptcy had been determined*”, i.e. the Net Investment Method) and fair and equitable (“*because it results in a share register which puts an equal value on the funds invested by all subscribers and does not give credit to those who succeeded in realising fictitious profits or penalize those who subscribed at a fraudulently inflated price*”). He also found that he had jurisdiction to apply this method because, once the register had been rectified in this way, the liquidator would still be making distributions to shareholders in accordance with the scheme of distribution mandated by section 140 of the Companies Law (i.e. on a *pari passu* basis in accordance with the number of shares recorded in the share register as being held by each shareholder). This was in contrast to both the Net Investment Method and the Rising Tide Method, under which distributions could be made without there being any need to rectify the share register at all, and which could therefore result in distributions being made (in form if not in substance) otherwise than on a *pari passu* basis.

The Primeo *in specie* distribution

The Judge went on to find that there was, however, no legal basis on which Herald’s additional liquidator could revisit the value of US\$465m ascribed in April 2007 to Primeo’s *in specie* subscription for shares in Herald, notwithstanding (i) that Primeo’s shareholding in BLMIS at that time was clearly worth significantly less than US\$465m because of the *Ponzi* scheme or (ii) the fact that Primeo, Herald and the BLMIS trustee had entered into a settlement recognising that Primeo’s net investment in BLMIS at that time had only been US\$149m. Because he had found in an earlier judgment that Primeo’s *in specie* subscription was not void on the grounds of mistake (i.e. a mistake as to the value of Primeo’s shares in BLMIS at the time), and because Madoff’s fraud was

“external” to Herald, the *in specie* subscription contract was binding and enforceable in accordance with its terms (i.e. at the NAV struck when Primeo subscribed to Herald) and could not be set aside under section 112 of the Companies Law. All that Herald’s liquidator could (and should) do was to rectify the register to ascribe to Primeo the number of shares which ought to have been issued to it at the “true” NAV of US\$1,000 per share based on its notional subscription of US\$465m. In other words, Primeo was treated as having paid US\$465m in cash for its shares in Herald (and would be allocated shares in the rectified register accordingly at a price of US\$1,000 per share), even though it had not done so, and the true value of its *in specie* subscription was substantially less. The economic outcome of this finding is that, in contrast to the other shareholders, Primeo will in effect have succeeded in realising fictitious profits of some US\$316m, being the difference between the value of US\$465m ascribed to its investment in BLMIS as of April 2007 and the amount of US\$149m which was the actual net amount of its investment at that time.

The judgment goes on to deal with a number of ancillary issues, which go beyond the scope of this briefing note, relating to the effect of share transfers before and after the suspension date, and the approach to be taken to translate Euro share claims into US dollar share claims.

Conclusion

The judgment demonstrates the willingness of the Cayman Court to adopt a creative, merits-based approach to the difficult distribution issues which arise when a Cayman fund is wound up because its assets were invested in a fraudulent scheme. That is generally to be welcomed, but while the decision appears to produce a broadly fair outcome as between the majority of Herald’s shareholders, it has put one shareholder, Primeo, in a substantially better position where it has ultimately benefited from Madoff’s fraud. The rationale by which that outcome has been reached is not entirely clear.

Although the Judge found that the NAVs were binding as a matter of contract on Herald and all of its shareholders, including Primeo, he concluded that the share register could nevertheless be rectified by replacing the NAVs calculated by the fund with a fixed NAV of US\$1,000 / €1,000 per share. The substantive effect of that decision as against all shareholders, including Primeo, is to override their binding subscription agreements insofar as those agreements provided that shares would be issued based on the NAV determined by the Fund.

But if the Judge is correct in finding (effectively) that there is statutory jurisdiction to override that term of Primeo’s binding subscription agreement, why would the jurisdiction not extend to overriding the other term of that agreement by which a notional value of US\$465m rather than US\$149m was ascribed to Primeo’s *in specie* subscription, when that result could also have been achieved through the mechanism of rectifying the share register (i.e. by recording Primeo as holding 149,000 shares based on a subscription of US\$149m at US\$1,000 per share)? In other words, was the Judge right to construe the liquidator’s power of rectification as providing only a class remedy (i.e. limited to a blanket restatement of the NAVs), and to couch any restatement of Primeo’s subscription *amount* as being an interference with an individual shareholder’s proprietary rights, and therefore beyond the liquidator’s statutory powers?

It remains to be seen whether an appeal will be brought, but it does seem likely given the amounts at stake, the novelty and complexity of the legal issues, the perceived inequity of the outcome and the history of earlier appeals in these proceedings.

[1] *Michael Pearson (as Additional Liquidator of Herald Fund SPC (in Official Liquidation)) v Primeo Fund (in Official Liquidation)*, unreported, 2 September 2016.



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