

Getting priorities in order: the Privy Council ranks redeemers in *Pearson v Primeo*

In *Pearson v Primeo* [2017] UKPC 19, the Privy Council has clarified (i) the status and (ii) the priority in a liquidation of investors who seek to redeem their shares in a Cayman Islands fund before the commencement of its winding up but who remain unpaid. Their Lordships also explored the circumstances in which section 37(7) of the Companies Law would apply, its purpose and effect.

For a discussion of the decisions by the Grand Court and the Cayman Islands Court of Appeal (“CICA”), please click [here](#) and [here](#) respectively. The Privy Council upheld the first instance and the CICA decisions.

In summary, when investors seek to redeem their shares prior to the commencement of the winding up of a fund but are not paid:

- Investors who are treated as having redeemed their shares under the articles of association before the commencement of the winding up (“**Redemption Creditors**”) may prove in the liquidation as creditors. They will rank ahead of unredeemed shareholders, but their claims are subordinated to those of ordinary creditors by section 49(g) of the Companies Law.
- Investors who were entitled to have had their shares redeemed before the commencement of the winding up (but who, for whatever reason, were not in fact redeemed by the fund) may seek an alternative path to redemption, through the pearly gate of section 37(7)(a) (“**Section 37(7) Claimants**”). If successful, Section 37(7) Claimants will also rank behind ordinary creditors but ahead of unredeemed shareholders as a result of section 37(7)(b), despite themselves being shareholders. If they cannot bring themselves within section 37(7)(a) then they rank equally with unredeemed shareholders. The Privy Council left open the question of the respective ranking of Redemption Creditors and Section 37(7) Claimants.
- Any other investor who was not entitled or did not attempt to redeem its shares before the commencement of the winding up will rank as an unredeemed shareholder, behind the claims of ordinary creditors, Redemption Creditors and Section 37(7) Claimants.

Background

If a Cayman Islands fund receives requests from investors to redeem their shares, imposes a suspension of redemptions and goes into liquidation without having paid redeeming investors, the precise sequence in which these events occur will have a bearing on both (i) the status of the investor and (ii) the priority of the investor’s claim in the liquidation.

The Privy Council considered three sequences arising out of the impact of the Madoff fraud on Herald Fund SPC (“**Herald**”) and its investors:

[Scenario A]: Redemption Notice -> Redemption Date -> Suspension -> Liquidation

This was the sequence applicable to Primeo Fund (“**Primeo**”), an investor in Herald which had given notice to redeem shares on a redemption date of 1 December 2008. It was common ground that those shares were in fact redeemed on 1 December 2008 in accordance with Herald’s articles of association.

On 12 December 2008, in light of the Madoff fraud having come to light, Herald’s directors suspended (among other things) redemptions of shares and the payment of redemption proceeds.

The suspension was not lifted prior to Herald being put into liquidation. Primeo was not paid its redemption proceeds.

[Scenario B]: Redemption Notice -> Suspension -> Redemption Date -> Liquidation

This was the sequence applicable to Reichmuth & Co (“**Reichmuth**”), an investor in Herald which gave notice to redeem its shares on a redemption date of 2 February 2009. Adequate notice having been given, Reichmuth would have become entitled to be redeemed on 2 February 2009. But prior to the redemption date, the suspension had been imposed. As with Primeo, Reichmuth did not receive its redemption proceeds.

[Scenario C]: Suspension -> Redemption Notice -> Redemption Date -> Liquidation

This was the sequence applicable to Natixis SA (“**Natixis**”), an investor which only made a request to redeem its shares after the suspension had been imposed on 12 December 2008. Natixis too was not paid its redemption proceeds.

Issues

In each of scenarios A, B and C, the key issues were:

1. Is the investor a creditor or a member of the fund for the purposes of the liquidation?
2. In either case, where will the investor’s claim rank in terms of priorities?

Central to the arguments was the applicability, purpose and meaning of section 37(7)(a) of the Companies Law, which provides in relevant part as follows:

“(7)(a) 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...”

A shareholder which can bring itself within section 37(7)(a) will, as a result of section 37(7)(b), rank ahead of other shareholders but behind ordinary creditors.

Scenario A

Issue 1: Creditor or Member?

The Privy Council upheld the decision of the CICA that Primeo was a creditor, and that section 37(7) of the Companies Law was never engaged because Primeo’s shares had been redeemed before Herald’s liquidation. In Primeo’s case, section 37(7) was a red herring.

The status of the investor in Scenario A depends on the construction of the articles of association of the fund and whether the fund has complied with the terms of redemption, such that under the articles the investor is to be treated as having redeemed its shares. The articles are capable of treating the redemption of shares and the payment of redemption proceeds as separate concepts, rights and obligations. The Companies Law does not make payment an inherent element of redemption.

If the investor is to be treated as having redeemed its shares under the articles, as was the case with Primeo, the investor will be a creditor in any subsequent winding up of the fund, with a claim for any redemption proceeds not paid prior to the winding up. Section 37(7) of the Companies Law is not capable of having any application in those circumstances because the investor’s shares have already been redeemed (even though the investor has not been paid), rather than being liable to be redeemed.

By contrast, the investor will be a shareholder if for whatever reason the fund has failed to take the steps which the articles require must be taken in order to complete the redemption, such that the investor’s shares are not redeemed prior to the liquidation (despite the investor having been entitled to have its shares redeemed). In those circumstances section 37(7) is relevant.

An investor whose shares have not been redeemed will want to bring itself within section 37(7)(a) of the Companies Law in order to enforce its right to redemption under that section, and take advantage of the priority afforded by section 37(7)(b) over other unredeemed shareholders. Such an investor can bring itself within the first part of section 37(7)(a) if it has, at the commencement of the winding up, “*shares which are or are liable to be redeemed [which] have not been redeemed*”. However, the investor will not be able to bring itself within section 37(7)(a) if the terms of redemption provided for the redemption to take place at a date later than the date of the commencement of the winding up (“**Proviso (i)**”), or in certain other circumstances.

Issue 2: Priorities

The Privy Council upheld the decision of the CICA that Primeo's claim as a Redemption Creditor was a creditor claim ranking before shareholders but subordinated by virtue of section 49(g) to claims of ordinary creditors. The application of section 49(g) to members and *former* members, such as Redemption Creditors, was common ground between the parties and was therefore not argued on appeal to the Privy Council.

Although the issue did not arise on the facts of the case and so remains to be decided, the CICA had observed that the claims of Redemption Creditors and Section 37(7) Claimants would rank equally as between themselves. In the Privy Council the Board declined to comment on that issue because it had not heard detailed submissions from counsel. The point therefore remains open for argument in another case, although Section 37(7) Claimants may prove to be rare creatures in practice.

Scenarios B and C

Issue 1: Creditor or Member?

Scenarios B and C were not argued in the Courts below. They were argued before the Privy Council as a result of permission being given to Reichmuth and Natixis to intervene.

In each of Scenarios B and C, the investor's shares will not have been redeemed and the investor will remain a shareholder. Reichmuth and Natixis were shareholders.

Issue 2: Priorities

Reichmuth sought to bring itself within section 37(7)(a) on the basis that, at the time of the commencement of the winding up, it had "*shares which are or are liable to be redeemed [but] have not been redeemed*". But Reichmuth was unable to take advantage of section 37(7)(a) and rely on the priority of section 37(7)(b) because it was caught by Proviso (i).

Reichmuth's redemption request was made for redemption on 2 February 2009 (a date prior to the commencement of winding up of Herald). Reichmuth's redemption notice ran its course and it became entitled to have its shares redeemed on the future redemption date of 2 February 2009. But the effect of the suspension imposed on 12 December 2008 was to suspend the right to redemption under the articles, to be revived when and only if the suspension was lifted. As the suspension continued until the commencement of the winding up, the terms of redemption were to be regarded as having provided for redemption to take place "*at a date later than the date of the commencement of the winding up*", within the language of Proviso (i).

As for Natixis, the suspension had been declared before Natixis made its request for redemption of its shares. So, Natixis's redemption request may have been invalid, since under the articles the suspension that had been imposed suspended the right to have shares redeemed; but the Board did not need to decide the point. If Natixis could bring itself at all within the first part of section 37(7)(a), it was also caught by Proviso (i).

Commentary

The purpose of section 37(7) of the Companies Law is to grant investors who were entitled before a liquidation to have their shares redeemed (but who were not in fact redeemed) priority in a fund's liquidation over other unredeemed shareholders. The section cannot (as Herald sought to do) demote an investor who has ceased to be a shareholder and become a Redemption Creditor, by returning the investor to the status of a shareholder – a status the investor has already surrendered.

These conclusions do not render section 37(7) of the Companies Law redundant. The section might apply in circumstances where (i) the articles of a fund provide that redemption occurs only after redemption proceeds are paid; or (ii) in circumstances where for whatever reason the company has failed to comply with certain formalities necessary to redeem an investor who is entitled to be redeemed in accordance with the redemption terms, although this is likely to be rare in practice.

Further, the fact that a Redemption Creditor such as Primeo may thereby be entitled to prove in the liquidation for a debt that includes an element of fictitious profits from a fraud, such as Madoff's, is irrelevant. As explained in *Fairfield Sentry Ltd v Migani* [2014] UKPC 9, an investor who withdraws from a fund before a *Ponzi* scheme collapses will escape without loss and quite possibly with substantial profits. The loss falls entirely on investors who remain shareholders of the fund at the time the scheme fails. A Redemption Creditor has surrendered his status as a shareholder, together with all attendant rights and risks to which continuing shareholders remain subject.

The Privy Council's decision in *Pearson v Primeo* provides welcome certainty on important areas of Cayman Islands law which had previously provided fertile ground for disputes in fund liquidations.



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