

Share Register Rectification: Primeo v Additional Liquidator of Herald

When settling a list of shareholders in a solvent liquidation of a Cayman Islands company that has issued redeemable shares tied to a NAV, what is the scope of an official liquidator's *power* to rectify the register of members under section 112(2) of the Companies Law? When does an official liquidator have a *duty* to rectify the register under that provision?

In *Primeo Fund ("Primeo") v Additional Liquidator of Herald Fund SPC ("Herald")* (CICA 5/2017), the Cayman Islands Court of Appeal ("CICA") heard an appeal by Herald's additional liquidator ("**Additional Liquidator**") concerning the ambit of section 112(2). The CICA held (reversing Mr Justice Jones QC) that:

- the power to rectify a share register under section 112(2) can be exercised **only** to give effect to the shareholders' existing rights by a process of rectification which, if not effected, would mean that the true legal position was not entered on the register. It does not confer a power to remove rights, to vary rights, or to create new rights;
- an official liquidator will be under a duty to exercise the power under section 112(2) if the NAV is incorrect and does not bind the company or its shareholders as a matter of contract law and, specifically, the proper interpretation of the articles of association of the company; and
- on the facts of the case, Herald's NAVs were binding, and so the Additional Liquidator did not have any duty to rectify the register, nor did he have any discretion to do so under the statute.

The CICA also heard an appeal by Herald's Additional Liquidator on a discrete issue in connection with Primeo's 'in specie' subscription for shares in Herald. The CICA upheld Mr Justice Jones QC's finding that the 'in specie' subscription was not void.

Legislative background

Section 112(1) of the Companies Law provides that the official liquidator "*shall settle a list of contributories*" for which purpose the liquidator "*shall have the power to adjust the rights of contributories amongst themselves*". This is not an unusual provision in Commonwealth jurisdictions.

By contrast, the CICA noted that section 112(2) is "*unusual, if not unique*", in that it gives an official liquidator of a solvent company that has issued redeemable shares tied to a NAV "*the power to settle and, if necessary rectify the company's register of members, thereby adjusting the rights of members amongst themselves*".

Section 112(2) does not give details about when an official liquidator is required to rectify the register, or how he should go about doing so. This falls to secondary legislation in the form of Order 12 rule 2 of the CWR ("**Rule 2**").

Rule 2 provides in part that:

- the liquidator shall exercise his power of rectification if he is satisfied that, amongst other things, the company has issued or redeemed shares "*at prices based upon a mis-stated net asset value which is not binding on the company and its members by reason of fraud or default*" with the result that the company has issued the wrong number of shares for the consideration received, or paid out the wrong amount in redemption proceeds; and
- the liquidator's task is to determine a "*true net asset value*" for each relevant redemption date or, if that is "*impractical or not cost effective*", to rectify the register "*in such manner which is both cost effective and fair and equitable as between the shareholders*".

Decision on section 112(2) and Rule 2

At first instance, Mr Justice Jones QC had held that:

- Section 112(2) gives the liquidator a discretion to rectify the register of members; Rule 2 also sets out circumstances in which the liquidator has a duty to exercise the discretion.
- As a result of Rule 2, section 112(2) permits the rectification of the register of members in order to give effect to the substitution of 'true NAVs' for those which were misstated, even if the misstated NAVs would otherwise be binding as a matter of contract.

The CICA agreed with Mr Justice Jones QC that section 112(2) provided a discretion which, in circumstances provided for under Rule 2, would become a duty.

They reversed the learned judge on the second point, regarding the scope of the power under section 112(2). The CICA held that section 112(2) creates a power that cannot override the rights of members in a company.

The statutory power can be exercised only to give effect to existing rights by a process of rectification which, if not effected, would mean that the true legal position was not entered on the register. Section 112(2) does not confer a power to remove rights, to vary rights or to create new rights.

In other words, if a NAV is incorrect but contractually binding on a proper construction of the articles of association, the liquidator will have no power to calculate a correct NAV and substitute it for the incorrect NAV which, despite its incorrectness, had been calculated in accordance with a member's contractual rights. As the CICA held at paragraph 40:

"The register can be rectified in order to declare the rights which have accrued to a member in accordance with his contract and the general law governing that contract. The purpose is not to 'restore' the register of members to a position which reflects the substitution of true NAV or a nearly true NAV or a NAV which does not reflect

fictitious profits or which achieves substantial justice.”

Rule 2 does provide for a set of circumstances in which a liquidator has a duty to exercise the discretion under section 112(2) to rectify the register in accordance with his determination of the true NAV as at each relevant redemption date or, if not cost effective and practical, what is cost effective, fair and equitable.

However, the CICA clarified two important things about Rule 2. First, the duty under Rule 2 will only arise in circumstances where the contract between the shareholder and the company is not binding “*by reason of fraud or default*”.

Second, the mere fact that there is fraud or default will not, by itself, make a NAV non-binding. For reasons of legal certainty, the question of whether the NAV binds is determined by construing the articles of association.

The CICA rejected the Additional Liquidator’s arguments that the NAV was not binding on the facts of the case.

Primeo’s in specie subscription in Herald

In early May 2007, Primeo’s rights to the credit in its managed account with BLMIS were assigned to Herald in consideration for the issue to Primeo of USD class shares in Herald. After adjustments, Primeo received over 373,260 USD class shares in Herald for a notional subscription price of approximately US\$465m. This was referred to as Primeo’s “*in specie*” subscription in Herald.

The Additional Liquidator appealed a decision of Jones J that Herald was bound by the number of shares allotted to Primeo in the *in specie* subscription, which could not now be adjusted. The Additional Liquidator argued that the allotment was void on the basis of (i) insufficient consideration (the value ascribed to Primeo’s managed account with BLMIS containing an element of BLMIS’s fictitious profits) and/or (ii) on grounds of mistake.

The argument on mistake was not capable of surviving a separate decision of Jones J which was never appealed. By that separate decision, Jones J had held that whilst the parties may have been mistaken about the value of Primeo’s rights against BLMIS, that was not a ground upon which the subscription could be held to be void for mistake.

The CICA rejected the argument that the subscription could be void for insufficient consideration. There was held to be no route under section 112(2) to challenge the *in specie* subscription.

Comment

The CICA’s decision on the scope of section 112(2) of the Companies Law is grounded on the need for legal certainty over the quasi-contractual rights and obligations between a shareholder and a company. A liquidator does not have a statutory obligation (or discretion) to alter those rights.

Articles of association often provide that NAVs struck by the directors are binding, except in the absence of good faith. The practical effect of this decision may be that the power under section 112(2) is relevant to cases of

‘internal fraud’ within the investment fund being wound up, but not to cases of ‘external fraud’ such as Madoff’s which affected investment funds like Herald and Primeo. Each case will however turn on the construction of the fund’s constitutional documents.



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