Clawback's back (back again): The Privy Council rules on the power of a Cayman liquidator to rectify the register of members

In *Pearson v Primeo* [2020] UKPC 3, the Privy Council considered an appeal by a liquidator on the scope of section 112(2) of the Companies Law (2018 Revision) of the Cayman Islands. The provision relates to a liquidator's power "*to settle and if necessary rectify the company's register of members, thereby adjusting the rights of members amongst themselves*". The power arises only in the context of a solvent liquidation of a company which has issued redeemable shares at prices based upon its net asset value.

When a hedge fund suffers loss from investing with a third party who is a fraudster, the loss may fall unevenly as between the fund's investors, depending on their subscriptions and redemptions in the fund over time. Does a liquidator have the power equitably to 'adjust' shareholders' rights to any surplus in the liquidation of the fund, in order to even up those losses? Does the power to rectify go beyond the mere implementation of the shareholders' underlying legal rights?

The Board's opinion, expressed by Lord Briggs, was that section 112(2) was not so wide. In particular, the power of rectification was only to bring the register into line with the underlying legal rights of the members as they exist at the commencement of the liquidation. Those rights could not be rewritten by the liquidator to do justice as between the investors. Lady Arden's judgment dissents from the majority on the scope of section 112(2), although she agreed that the liquidator's appeal should not succeed.

Background

Herald Fund SPC (in Official Liquidation) ("**Herald**") was a hedge fund that placed all its assets under management with Bernard Madoff's firm ("**BLMIS**"). Herald and its investors were victims of Madoff's Ponzi scheme, though some investors fared better than others.

Primeo Fund (in Official Liquidation) ("**Primeo**") acquired the largest part of its equity position in Herald through an '*in specie* subscription' in 2007 when, not long before Madoff's fraud was discovered, the purported value in Primeo's remaining direct investments with BLMIS was assigned to Herald in exchange for Herald issuing new shares in Herald to Primeo. That value was overstated because of BLMIS's fictitious profits. Accordingly, Primeo received a windfall in terms of the number of new shares it received in Herald.

Appeal Unsuccessful

The liquidator (in this case the additional liquidator of Herald) argued that section 112(2), which came into force in 2009, permitted him to adjust the register of members of Herald in order to reflect the net sums invested by any given shareholder in Herald's equity (i.e. subscriptions less redemptions), rather than reflecting the shares they had in fact been issued.

The Board disagreed on the basis of statutory construction. Although the power afforded to liquidators under section 112(2) was novel, the Board said that it relied on familiar concepts of rectification *"in its ordinary and time-honoured sense"*. Under section 112(2), a liquidator has the power:

- to "settle" the register of members if it is incomplete, for example if there was a management failure shortly before liquidation; and
- to "rectify" the register if it is complete but plainly wrong, i.e. to correct an error in the register so as to bring it into line with the underlying legal rights of the parties affected by it as at the commencement of the liquidation.

The Board's view was that the liquidator's power of rectification under section 112(2) was similar to the Court's power to order the rectification of a company's register of members under section 46 of the Companies Law. There could be no departure from the legal rights of the persons concerned, when "*adjusting the rights of members amongst themselves*".

Policy reasons supported that same conclusion. If the liquidator were right, that would represent an unprecedented change in the law, since "*it would empower liquidators to impose a scheme of fair distribution of their own devising in substitution for the members' legal rights*". That cannot have been the intention of the legislature, particularly as there was no debate about such a radical change at the time the provision was being considered. It would also be contrary to the fundamental principle that assets are to be applied *pari passu* among the classes of stakeholders in accordance with their legal rights at the commencement of the liquidation.

The appeal was therefore unsuccessful. The Board did not separately have to consider the application of section 112(2) to the issue of Primeo's *in specie* subscription. It was common ground that Primeo was contractually entitled to insist on the valuation of its investment in BLMIS upon which its subscription in Herald was based. It followed that that was a (contractual) right which the liquidator could not disturb by rectification of the register of members under section 112(2). The Privy Council did, however, express regret as to their conclusion saying "*a net investment method of distribution would be regarded by most reasonable observers as offering a fairer, although still imperfect, method of allocating between members the consequences of having been caught up in a Ponzi scheme*".

Dissenting View on the Scope of Section 112(2)

Lady Arden agreed that the appeal should fail. She expressed, however, a dissenting view on the scope of section 112(2). She considered that section 112(2) was not co-extensive with section 46, since the latter confers on the Court the power to rectify the register of members but not a power to adjust the rights of members.

Lady Arden said that rectification is "*not authorised except for substantial compliance with the members' rights*", but, since section 112 also confers on the liquidator power to adjust the rights of the contributories (or members), rectification is not confined to contractual rights.

In her view, the liquidator can also take account of any obligation which the member has to the company, however arising. Rights can be adjusted not simply to reflect the contributories' contractual rights as holders of shares in issue at the date of the winding up, but also to ensure that all debts due from the contributory to the company are paid before the contributory becomes entitled to share in the surplus assets.

Such indebtedness could include a liability to repay redemption proceeds that were paid by the company unlawfully. Redemption proceeds can be paid by a company out of profits, share premium, or (if authorised in the articles and subject to a solvency test) out of capital. Under section 34 of the Companies Law, the company's share premium account should include "*a sum equal to the aggregate amount of the value of the premiums on those shares*". Lady Arden's view was that 'value' in section 34 is not a good faith assessment by the directors (unlike the value of a NAV that might be struck and bind); it refers to the true, intrinsic value.

It is now clear that the true 'value' of the premium on the new shares that investors acquired in Herald upon subscription was grossly overstated. For the purposes of section 34, the available value in the share premium account, at the time of any redemption request, was therefore lower than it appeared to the directors of Herald and, according to Lady Arden "*might therefore have to be adjusted downwards with retrospective effect*". In addition, Herald's articles of association did not permit a payment out of capital. In those circumstances, it is conceivable that payment of redemption proceeds to a given redeemer could have been unlawful – and could therefore be taken into account by a liquidator under section 112(2).

Indeed, in actuality, the true value of the share premium account of Herald (or any BLMIS feeder fund) is likely to have been zero and redemptions were only made possible by payments from BLMIS to meet those liabilities. Lady Arden expressed the provisional view that in a case where payments were made unlawfully, a liquidator would have the power to rectify the register of members to reinstate the holders of redeemed shares and demand repayment of the redemption monies paid to them or, indeed, to depart from shareholders' strict legal rights and adjust entitlements to repayment of capital as among remaining shareholders using section 112 and sue for any balance.

Finally, Lady Arden suggested a fallback if the liquidator found it virtually impossible to work out the rights of individual members using her proposed analysis or if the legal rights of investors are to be adjusted further than section 112 permits. The suggestion was that a liquidator might have to promote a scheme of arrangement under section 86 of the Companies Law to achieve the same ends.

Conclusion

Lady Arden confined her opinion to the power of rectification under section 112(2), and to investors who redeemed only some shares and so remained shareholders at the commencement of the liquidation as they were the only class of persons affected by the proposal in Herald. Nevertheless, her opinion may encourage claims at common law by liquidators seeking effectively to claw back redemption proceeds paid to investors – or former investors – if such payments are held to be unlawful payments out of capital. While Lady Arden's comments are obiter dicta they will be considered in future Cayman fund liquidations where the NAV is found to have been artificially or fraudulently inflated for possible recoveries and distribution methodologies that might have previously been thought unachievable under Cayman Islands law.

Lady Arden sought to distinguish other Privy Council cases that appeared to have shut the door on "clawback" actions; however, rather than bring about investor certainty, it seems likely that the interplay between this and other authorities will be the subject of further dispute.

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