Tough Luck for Unpaid Shareholders - RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund (In Official Liquidation)

In a recent decision of the Grand Court of the Cayman Islands, Smellie CJ has found that redeemed shareholders are entitled to retain redemption proceeds paid to them by a fund even though the fund was cash flow insolvent at the time of the payment. The Judge found that the Companies Law (2007 Revision) (the "Law") (applicable at the relevant time) did not prohibit the use of share premiums for the redemption of shares when permitted by a fund's articles, even when insolvent, because by operation of section 34(2)(f) as it then stood, payments out of share premiums were not to be regarded as payments out of capital.

In a lengthy judgment, the Judge set out an array of reasons for rejecting the liquidators' contention that the payments to RMF fell foul of section 37(6)(a) of the Law which, reflecting the common law preservation of capital rule which originally developed to protect creditors, stated that:

"*a payment out of capital by a company for the redemption or purchase of its own shares is not lawful unless immediately following the date on which the payment out of capital is proposed to be made the company shall be able to pay its debts as they fall due in the ordinary course of business*."

The par value of the shares in the DD Growth Premium 2X Fund was US$0.001 and the Judge found that the redemption monies were, in substance, paid out of the share premium, the price of the shares having been calculated at the date of redemption to be US$118.88. The liquidators argued, on behalf of the fund, that a redemption payment out of share premium fell within s 37(6)(a), by virtue of the deemed meaning of the phrase "*payment out of capital*" under section 37(5)(a) and (b), which included payment "*otherwise than out of its profits or the proceeds of a fresh issue of shares*". It must, the liquidators submitted, therefore include payment out of share premium.

The Judge rejected this argument as a "*tortuous and strained*" construction of the statute. He expressed the view that many Cayman investment companies operated on the basis that redemption payments were made in the ordinary course of business from profits, share premiums and the proceeds of fresh issues of shares.

He also found the liquidators' position to be inconsistent with section 34 of the Law, under which a sum equal to the total value of share premiums must be transferred into a share premium account. Subject to the fund's articles, the balance of the share premium account can be used as set out in subsection (2), including, in the Law as it then was, subsection (2)(f): "*providing for the premium payable on redemption or purchase of any shares or* *debentures of the company*". The Judge found that section 34 was not subject to section 37 but was instead a separate regime dealing with payments out of share premium.

In support of his conclusion, the Judge pointed to the changes to the Law brought in by the 2011 Amendment Law, which included adding payments out of "*share premiums*" to the list of payments not to be deemed payments out of capital under section 37(5)(b). The 2011 Amendment Law also removed the reference in section 34(2)(f) permitting the share premium account to be used to pay redemptions. The Judge regarded this as a natural consequence of the clarification of section 37.

The purpose of capital preservation requirements is to protect a company's creditors. At common law, the default position is that company assets cannot be distributed to shareholders, unless statute provides otherwise. Such a distribution is defined as a return of capital and is accordingly unlawful at common law (*Progress Property Co Ltd v. Moore* [2010] UKSC 55). Thus, the definition of capital is potentially broad but is limited by statute.

On Smellie CJ's construction of the Companies Law, the common law rule has a very narrow application in the context of Cayman funds. He appears to have confined the asset-preserving effect of section 37 of the Law solely to the amount of paid up share capital. The effect is especially marked when, as is typical in funds, shares are issued at a substantial premium and have only a very small nominal value. In these cases, the capital preserved will likely be insufficient to benefit the fund's creditors in any meaningful way, should the fund become insolvent.

The Judge acknowledged that as a result of this approach the fund's losses would be borne substantially by the unredeemed shareholders and, whilst unfair, that was the unfortunate consequence when an investment fund became a *Ponzi* scheme. It could have been avoided had the directors taken steps to suspend the NAV calculation and redemptions when it became apparent that there were cash flow issues. He also noted that the payment from share premium was not a payment of other investors' money, but a return of the investor's own investment in circumstances where there was very little exposure to risk of liability to third party creditors whose interests would need to be protected in the event of insolvency.

The Judge found comfort in the fact that the constitutional documents of the fund set out that shareholders could expect to be paid on a "first come first served" basis; the articles gave "notice to all the world" that this was how the fund would operate. In circumstances where payments were made in accordance with the articles and specific statutory provisions, there was no breach of the capital preservation rule.

A further argument that the payment to RMF was a fraudulent preference under section 168(1) was rejected on the facts.

It remains to be seen whether the decision will be appealed by the liquidators.

Mark Goodman
Partner

+1 284 340 6159
mgoodman@campbellslegal.com