

UPDATE

# Cayman Court gives guidance on the status of redeeming investors and approach to distributions

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The Grand Court of the Cayman Islands (the **Court**) recently ruled in favour of Primeo Fund (in official liquidation) (**Primeo**) in its ongoing representative proceedings with the Additional Liquidator of Herald Fund SPC (in official liquidation). The Court confirmed that section 37(7)(a) of the Companies Law does not apply to investors who are redeemed pursuant to the company's articles of association, but have not yet been paid (the section 37(7) Issue).

The Court has now handed down its detailed reasons in respect of both the section 37(7) Issue and the other matter it was asked to determine: the circumstances in which a liquidator of a Cayman company can rectify the register of shareholders pursuant to section 112(2) of the Companies Law and Order 12 rule 2 of the Companies Winding Up Rules.

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## Background

Primeo invested in Herald, which in turn invested in Bernard L Madoff Investment Securities LLC (**BLMIS**), which turned out to be the world's largest Ponzi scheme run by Bernard Madoff.

Primeo, along with a number of other Herald shareholders, submitted redemption requests in respect of certain of its shares (the **Shares**) for a redemption date of 1 December 2008 (the **December Redeemers**). Herald accepted those requests and it was conceded by Herald that, as a matter of law, the Shares had been redeemed on 1 December 2008.

On 11 December 2008, before the redemption monies were paid to Primeo, Madoff confessed that BLMIS was an elaborate fraud. This resulted in Herald passing resolutions suspending the determination of NAV and the payment of unpaid redemption monies. On 23 July 2013, upon the petition of Primeo, liquidators were appointed over Herald.

Primeo was appointed as a representative party on behalf of the December Redeemers and Herald's Additional Liquidator was appointed as the representative party on behalf of all investors who were not December Redeemers. Primeo and the Additional Liquidator were also appointed as representative parties in respect of the Rectification Issue.

## The section 37(7) Issue

Section 37(7)(a) of the Law provides that:

- (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...

Primeo argued that, on a plain reading, the first paragraph of section 37(7)(a) does not apply to shares which have been redeemed. Primeo maintained that:

- section 37 of the Law is intended to govern the manner in which an investor may redeem its shares in a Cayman Islands company. As such, the terms used in its subsections must be construed consistently;
- the Privy Council in *Strategic Turnaround Master Partnership Limited v Culross Global SPC Limited* [2010] 2 CILR 364 had determined that, for the purposes of section 37(3)(c) of the Law, when a company's shares will be regarded as redeemed is determined by reference to the company's articles of association;
- if the legislature had intended 'redemption' in the context of section 37(7)(a) to bear a different meaning, it would have made this clear; and
- as Herald accepted that Primeo and the other December Redeemers had been redeemed on the Redemption Day pursuant to section 37(3)(c), Primeo must also be redeemed for the purposes of section 37(7)(a).

Herald's position was that redemption, in the context of section 37(7), was something different from redemption under its articles of association. Herald argued that redemption, for the purposes of section 37(7), meant a process that was only completed at the time of payment of the redemption proceeds. This view of the process of redemption was specifically rejected by the Privy Council in *Strategic Turnaround*, but Herald argued that authority did not apply in these circumstances.

### **The Court's ruling on the section 37(7) Issue**

The Court agreed with Primeo's analysis and held that section 37(7)(a) of the Law did not apply to the Shares. Herald's position was found to be inconsistent with binding authority.

The Court held that the purpose and effect of section 37(7)(a) was clear. It did not seek to deal with the position of redeemed investors but rather set out the circumstances in which shareholders who had submitted a redemption request but had not been redeemed could enforce that redemption against the company, in a liquidation.

The Court's ruling provides welcome guidance on the construction of section 37(7)(a). It confirms that a fund and its redeemed investors will be bound by the contractual arrangements which they entered into (as set out in the fund's constitutional documents), even where the fund is in liquidation.

### **The Rectification Issue**

The Court was also asked to determine the circumstances in which a liquidator will be permitted to rectify the register of members of a company pursuant to section 112 of the Law and/or Order 12, rule 2 of the CWR.

Section 112 of the Law provides:

1. The liquidator shall settle a list of contributories, if any, for which purpose he shall have power to adjust the rights of contributories amongst themselves.
2. In the case of a solvent liquidation of a company which has issued redeemable shares at prices based upon its net asset value from time to time, the liquidator shall have power to settle and, if necessary rectify the company's register of members, thereby adjusting the rights of members amongst themselves.
3. A contributory who is dissatisfied with the liquidator's determination may appeal to the Court against such determination.

Order 12, rule 2 of the CWR, in turn, provides:

1. The official liquidator shall exercise his power to rectify the company's register of members under section 112(2) if he is satisfied that:
  - (a) the company is or will become solvent;
  - (b) the company has from time to time issued redeemable shares at prices based upon a mis-stated net asset value which is not binding upon the company and its members by reason of fraud or default, with the result that the company has issued an excessive or inadequate number of shares in consideration for the prices paid by one or more subscribers; and/or
  - (c) the company has redeemed shares at prices based upon a mis-stated net asset value which is not binding upon the company and its members by reason of fraud or default, with the result that the company has paid out excessive or inadequate amounts to former members in consideration for the redemption of their shares.

Herald's articles of association (**Articles**) provided that NAVs were binding on all persons if, in determining the NAVs, Herald's directors acted bona fide in the best interests of the company. Such provisions are relatively common in the articles of Cayman Islands mutual funds.

Primeo argued that:

- whilst section 112(2) created the power to rectify, the circumstances in which that power could be exercised were prescribed by Order 12, rule 2 (**Rule 2**);
- on a plain reading, Rule 2 required the Additional Liquidator to establish that Herald's NAVs were not binding upon Herald and its members by reason of fraud or default. In other words, the Additional Liquidator was required to establish that there was some fraud or default which had the effect of vitiating the otherwise legally binding effect of the NAV on Herald and its members; and
- if section 112(2) did establish a power to rectify which was broader than set out in Rule 2, it could only be exercised in circumstances where the Additional Liquidator could establish some conduct which had the effect of vitiating the otherwise legally binding effect of the NAV on Herald and its members.

The Additional Liquidator's position was that:

- section 112(2) and Rule 2 created separate, free standing bases upon which to rectify a company's register and the question of whether the NAVs were contractually binding as between the company and its members was irrelevant;
- the requirement to rectify the register pursuant to Rule 2 would be triggered if the NAV was mis-stated due to any fraud or default, irrespective of the nature of the fraud or default or by whom it was committed. The Additional Liquidator contended that, in those circumstances, the mis-stated NAVs were not binding by operation of Rule 2 itself. Accordingly, he argued that it was unnecessary to establish that the relevant fraud or default would have the effect of vitiating the agreement contained in the Articles; and
- the Additional Liquidator argued that section 112(2) provided him with a standalone discretionary power to settle and, if necessary, rectify Herald's register where the justice of the case required.

### **The Court's ruling on the Rectification Issue**

The Court agreed with Primeo's construction of Rule 2. It held that the plain language of Rule 2 required the Additional Liquidator to establish that the NAV was not binding between Herald and its members as a result of 'some conduct on the part of the company itself or conduct on the part of an agent which can properly be imputed to the company which has the effect of vitiating the contract with its members.'

Echoing the dicta of the Privy Council in *Fairfield Sentry Ltd v Migani* [2014] UKPC 9, the Court found that the need for commercial certainty meant that the determination of a company's NAV, which was binding pursuant to its articles, should not be open to challenge 'whenever it could be said, with the benefit of hindsight, that it had been mis-stated by reason of fraud or default in some way which would not have the effect of vitiating the contract.'

The Court noted that the Additional Liquidator had not made any allegation that Herald's directors had not acted bona fide in the best interests of Herald. Accordingly, the Additional Liquidator's case in respect of Rule 2 had to fail.

In relation to section 112(2), the Court found that the power to rectify was broader than that contained in Rule 2. The Court did not go on to determine the full scope and limits of the power. Whether the

Additional Liquidator can properly exercise the power under section 112(2) is to be determined at a future hearing. However, the Court did make it clear that the power contained in section 112(2) is a power to rectify the register, which 'does not enable the Additional Liquidator to impose upon Herald's shareholders a scheme of distribution which is inconsistent with the requirements of section 140(1) of the Companies Law.' In doing so, the Court rejected the Additional Liquidator's attempts to adopt the net equity scheme of distribution used by the BLMIS Trustee in the US. The process of rectification instead involves re-stating the number of shares that ought to have been issued or redeemed if the transactions had been conducted at a true NAV.

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