

UPDATE

DD Growth: Privy Council extends the scope of clawback remedies

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The liquidators convinced a majority of the Board of the Privy Council that substantial redemption payments made to an investor (RMF) were payments made out of capital at a time when DD Growth was insolvent. The liquidators successfully argued that the payments were unlawful and the Grand Court will now have to decide whether redemption proceeds should be returned to the DD Growth estate by RMF as a constructive trustee.

Another important judgment has been handed down by the Privy Council in relation to redemptions out of Cayman Islands investment funds, following the decision in *Pearson v Primeo Fund*¹ earlier this year. Unlike the Primeo Fund example, redemption proceeds had been paid on this occasion and the Privy Council was tasked with determining the lawfulness of such payments.

It was third time lucky for the liquidators in *DD Growth Premium 2X Fund (In Official Liquidation) v RMF Market Neutral Strategies (Master) Limited*². Following losses in the Grand Court and Cayman Islands Court of Appeal (CICA), the liquidators of DD Growth were at least partly successful at the final stage in the appeal process.

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Background

DD Growth suffered catastrophic losses as a result of the Global Financial Crisis in 2008. Between the start of October 2008 and the end of November 2008, DD Growth lost approximately USD 250 million.

RMF was one of the largest investors in DD Growth. In October 2008, RMF sought to redeem the majority of its shares in DD Growth in two tranches. Both redemption requests, which amounted to a combined redemption of close to USD 62 million (based on false information), were allocated a trade date of 1 December 2008. RMF was paid approximately USD 23 million in cash in January 2009 (i.e. more than one-third of its combined redemption).

Not long after payments were made to RMF and certain other December redeemers, DD Growth suspended redemptions. By March 2009, DD Growth had been placed in court-supervised liquidation.

¹ [2017] UKPC 19; our update on this matter can be found [here](#).

² [2017] UKPC 36

In response to an application by RMF for a negative declaration that it was not liable to repay the redemption proceeds, the liquidators sought to clawback the entire USD 23 million cash payment.

Key provision

Section 37(6) of the Companies Law (2007 Revision) (as it was at the material time) (the **Law**) states 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.

Therefore, the issue was whether the payment was made out of 'capital' and whether or not DD Growth would have met the solvency test under that provision.

Lower Court's decisions

At first instance, it was decided that: (i) DD Growth was insolvent at the material time; (ii) the payments to RMF were not unlawful payments of capital; and (iii) there was no fraudulent preference. The Chief Justice held that DD Growth had used the fund's share premium account legitimately. As opposed to intending to prefer RMF, the Chief Justice decided that the intention was to avoid potential regulatory and legal consequences arising out of non-payment. The CICA ultimately reached the same conclusion. Given that neither Court considered that the payment was unlawful, there was no need to consider arguments on behalf of the liquidators in relation to remedies.

Privy Council decision

The Privy Council agreed that DD Growth would not have passed the solvency test as at 1 December 2008. The Board found that debts due to the December redeemers must be taken into account for the purpose of determining solvency. On that basis, DD Growth was certainly unable to pay its debts as they fell due.

However, unlike the courts below, the Board found in a split 3/2 decision that RMF was paid out of capital and as a result of the solvency issue, the payment was not lawful.

The Privy Council found that in defining "capital" under section 37(6), the Court needed to look at section 37(5)(b) which states that *any* payment made contrary to section 37(6) would be regarded as a payment of capital unless that payment was made out of profit or the proceeds of a fresh issue of shares. In other words, any payment made out of share premium for the redemption of shares in contravention of section 37(6) would be regarded as a payment out of capital.

The Privy Council made the point that the Cayman legislature could have expressly carved out payments from share premium when defining capital for the purposes of section 37(6) but chose not to do so. On that basis, the logical conclusion is that it must have intended that payments for the redemption of shares out of share premium be considered payments out of capital. As an aside, it was observed that the Cayman legislature did in fact clarify the position and amended the provision to exclude payments out of share premium accounts in the 2011 Revision of the Law. However, the 2007 Revision was the operative iteration here.

In reaching the opposite conclusion, the CICA had largely relied upon section 34 of the Law which provides that payments by a company out of share premium for the redemption of shares are not payments out of capital and not subject to any condition in relation to solvency. Based on section 34, it was argued that the insolvency test applies to distributions or dividends as opposed to redemptions. The Privy Council accepted that this was an attractive argument but was not persuaded by it. The primary issue from the Board's perspective was the fact that the use of share premium accounts for redemptions is dealt with in detail in section 37. Therefore, whilst share premium accounts may be referred to in other contexts in different parts of the Law, section 37 is the natural starting point for any statutory analysis in respect of redemption proceeds.

Having decided that the payments to RMF were unlawful, the Privy Council has sent the matter back to the Grand Court to consider the liquidators' remedies and whether RMF must return the redemption proceeds to the DD Growth estate.

Separately, the Privy Council rejected the liquidators' argument that the payment to RMF gave rise to a claim in unjust enrichment and a right of restitution. The Privy Council held that, unlike the payment to

RMF, the redemption itself was consistent with the fund's articles and not unlawful. Therefore, there was no failure of consideration and the liquidators could not meet one of the core requirements for a claim in unjust enrichment.

Comments

In the process of setting out the legislative history, the Privy Council expressly bemoans the fact that the Law has been revised in a piecemeal fashion over time. This observation is made after having dealt with section 37 and its interaction with other provisions of the Law on two occasions in quick succession. The fact that two high profile Cayman cases dealing with redemptions have made it to the Privy Council in recent months is helpful in terms of getting clarity on key issues but suggests that the operative sections regarding redemptions are laced with ambiguity.

The Grand Court will have to consider remedies against RMF and whether or not it is required to repay the redemption proceeds. The Privy Council have made it clear that the bar is relatively high. The payment may have been authorised by DD Growth's directors in breach of duty but the question of whether RMF knew that the payment was being made under those circumstances is a different question entirely. The Privy Council observed in passing that the knowledge aspect *may be hard to prove*.

This decision is likely to lead to interesting developments in this area and will be watched closely by liquidators seeking to advance clawback claims in Cayman.

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