

UPDATE

Liquidation distribution methodology for Investment Funds

Update prepared by Peter Hayden (Partner, Cayman Islands)

In a long awaited decision, the Privy Council has clarified that, in making distributions in a solvent liquidation, liquidators of Cayman Islands' hedge funds must do so in accordance with the legal rights of its investors.

The question of the methodology that can be adopted in the solvent liquidation of an investment fund under Cayman Islands law (where around 60% of the world's investment funds are incorporated) has been the subject of on-going litigation for several years but has now been resolved by the Judicial Committee of the Privy Council (the **Privy Council**). The Privy Council unanimously rejected the attempt to use a net cash methodology and found that distributions to investors should be based on shareholdings at the commencement of the liquidation.

The issues arose in *Pearson* (in his capacity as Additional Liquidator of Herald Fund SPC (in official liquidation))¹ v *Primeo Fund* (in official liquidation)². In previous litigation between the same parties on distributions to creditors, *Primeo* successfully established that redeemed investors rank as creditors in a liquidation and are entitled to be paid out in priority to shareholders (see our previous briefing [here](#)). This aspect of the litigation concerned shareholders' rights in the liquidation to the remaining estate after payment of all creditors.

Background

Primeo was an investor in *Herald* which had, in turn, invested substantially all its assets with Bernard L Madoff Investment Securities LLC (**BLMIS**). Under the relevant statutory provisions of United States' law relating to broker insolvencies, the BLMIS Trustee is required to make distributions from BLMIS on a net cash basis. The Additional Liquidator of *Herald* wished to use this method of distribution in relation to distributions from *Herald* because he believed that it would produce a fairer outcome for investors as a whole.

The Additional Liquidator sought to achieve this by arguing that section 112(2) of the Cayman Islands Companies Law (the **Law**), which allows a liquidator to rectify the company's register of members in certain circumstances, conferred on a liquidator a broad discretionary power to adopt a method of distribution which the liquidator believed produced the fairest outcome. He argued that this was a bespoke new power, introduced to the Law in 2009 to do justice and equity between investors, which permitted a liquidator to disregard investors' legal rights.

Primeo's position was that section 112(2) of the Law did not create a new power, but rather reflected the conventional power of rectification which could only be used to amend the register of members to give effect to a shareholder's existing legal rights.

¹ The **Additional Liquidator** and **Herald** respectively.

² [2020] UKPC3.

At first instance, the Grand Court of the Cayman Islands agreed with the Additional Liquidator and held that he had the power to rectify the register so as to do substantial justice between the parties, but that the net cash methodology was not a permissible method because it contravened section 140(1) of the Law, which requires distributions to shareholders to be made by reference to their shareholdings at the commencement of the liquidation. On appeal, the Cayman Islands Court of Appeal unanimously upheld Primeo's appeal finding that the Additional Liquidator's power was limited to rectification in the conventional sense. The Additional Liquidator appealed the Court of Appeal's decision to the Privy Council.

The question with which the Privy Council was confronted was *[i]s the liquidator's power to rectify the company's register of members confined to an alteration which brings the register into line with the members' underlying legal rights as at the commencement of the liquidation? Or is it wide enough to enable the liquidator to amend the register of members in a way which alters the members' legal rights, as at the commencement of the liquidation, so as to do what the liquidator conceives to be substantial justice as between the members, in a case in which, in the liquidator's view, justice would not be achieved by a distribution of the surplus assets of the company in accordance with their legal rights, as stated in the register?*

The Privy Council Decision

Lord Briggs delivered the judgment of the majority, with Lady Arden also considering matters separately. The Privy Council held that section 112(2), read in its proper context, did not permit the Additional Liquidator to ignore a shareholder's contractual and proprietary rights, and distribute on a basis other than that in accordance with those rights.

If the Additional Liquidator was correct, it would involve a *large and unprecedented* change in the law which was contrary to the *fundamental principle applicable to all liquidations in the Cayman Islands that the assets of the company must be distributed in accordance with shareholders' legal rights*. The Privy Council reasoned that, based upon a review of (a) the history of the Law and similar provisions in other commonwealth jurisdictions (such as the United Kingdom), (b) the statutory regime as a whole (including the entirety of the Law and its subordinate legislation such as the Cayman Islands' Companies Winding Up Rules) and (c) relevant supporting legislative materials (such as the report issued by the Cayman Islands Law Reform Commission prior the introduction of the relevant wording), the term rectification bore its settled, well-understood meaning; namely a means by which a register can be corrected to ensure a shareholder's legal rights are properly recorded. In reaching this finding the Privy Council followed its own previous decision in *Nilon Ltd v Royal Westminster Investments SA* [2015] 2 BCLC 1.

The legislature did not therefore grant a new power to liquidators but merely permitted them, in a liquidation, to personally exercise the conventional rectification power normally wielded by the court. Accordingly, the Privy Council found that the effect of section 112(2) of the Law is to permit a liquidator to do two things: (a) settle (i.e. complete or create) and/or (b) rectify (i.e. correct) a register of members so as to *make sure that the register is a reliable basis for distributing the surplus because it fully and accurately reflects the members' legal rights*³.

Conclusion

As noted by Lord Briggs, the scope and effect of section 112(2) is an important issue for the Cayman Islands' fund industry. The Privy Council's decision confirms the importance of the contractual and proprietary rights of shareholders.

The key difficulty with the approach proposed by the Additional Liquidator, in addition to the lack of any legal basis for it as set out above, is that it is wholly uncommercial and would leave investors at the mercy of a liquidator's view as to what may or may not be fair in any particular liquidation. It is unlikely that investors would be prepared to take that risk and potentially lose all their contractual rights, particularly in light of the very large sums commonly invested in investment funds. It is worth noting that, notwithstanding the Additional Liquidator's reliance on the method of distribution adopted in the US by the BLMIS Trustee, even if Herald had been incorporated in the US, it would not have been permissible for it to

³ Pursuant to section 48 of the Law, a company's register of members is deemed to be *prima facie* evidence of, *inter alia*, a company's members from time to time and the number and class of shares held by each of them.

distribute on a net cash basis. In the US, as in the Cayman Islands and other common law jurisdictions, it is only possible to disregard the contractual arrangements where the fund itself is a fraud, thereby vitiating the contractual rights. Where, as here, the fund itself is not a fraud but has simply inadvertently invested in a fraud, there is no basis for vitiating those contractual rights.

The Privy Council's decision should provide comfort to investors in investment funds incorporated in the Cayman Islands that their contractual rights will be respected. This has been the longstanding approach of courts in the Cayman Islands.

Peter Hayden and Christopher Levers acted for Primeo, instructing Tom Smith QC and Adam Al-Attar of South Square chambers.

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