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The Rule in *Houldsworth*: Cayman Court weighs in on century-long debate regarding the admissibility of shareholder misrepresentation claims in a liquidation

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The Grand Court of the Cayman Islands,[1] has held for the first time that shareholders who subscribed for shares in a Cayman company be permitted to prove in the liquidation for misrepresentation claims and that such claims will rank as unsecured debts of the company, ahead of redemption creditors and other members' claims. In reaching this decision, the Grand Court departed from the decision of the House of Lords in *Houldsworth v City of Glasgow Bank*.[2]

Background

HQP Corporation Limited (the **Company**) is an exempted company incorporated under the laws of the Cayman Islands. The Company was part of a group of companies in mainland China which had a business of trading automobile parts on an online platform. The Company raised capital for the business through private equity funding. Preferred shares were issued to investors following each round of funding (the **Preferred Shares**).

Various allegations were made against the Company including that the scheme of promotion of the Company was conducted on a fraudulent basis. The Company was placed into official liquidation and joint official liquidators appointed.

On 11 November 2022, the joint official liquidators sought directions from the Court on three issues:

1. the treatment of share redemption requests made pursuant to the Company's articles and in particular, whether putatively redeeming Preferred Shareholders remain members or become creditors in respect of their unpaid redemption proceeds (the **Redemption Issue**);
2. whether the Preferred Shareholders may in principle assert claims against the Company for damages for misrepresentation in relation to their subscription for shares in the Company (the **Availability Issue**); and
3. to the extent misrepresentation claims are available to the Preferred Shareholders, how such claims rank in the liquidation of the Company (the **Priority Issue**).

Decision

The Redemption Issue

On a proper construction of the Company's articles, this was not a case[3] where it was possible under the articles for a redeeming shareholder to be fully redeemed (and so cease to be a member) yet remain unpaid and become a creditor for a redemption price, as redemption only occurred under the articles upon payment by the Company. As such, the parties agreed, and Doyle J directed, that the Preference

[1] *In the Matter of HQP Corporation Limited (In Official Liquidation)* (Unreported, 7 July 2023, Doyle J) (***HQP Corporation Limited***).

[2] *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317.

[3] Such as *Culross Global SPC v Strategic Turnaround Master Partnership Ltd* 2010 (2) CILR 364 or *Re Herald Fund SPC* 2016 (2) CILR 330 (CICA); 2017 (2) CILR 75 (PC).

Shareholders who had submitted redemption requests but not received payment remained unredeemed shareholders of the Company.

The Availability Issue

Doyle J considered the long-standing rule established in the House of Lords decision in *Houldsworth v City of Glasgow Bank*[4] that a person induced by fraud to subscribe for shares can bring no action for damages against the company while he remains a shareholder. He cannot both retain the shares and sue the company for damages. His only remedy is recission of the contract which becomes impossible after the winding up of the company commences.

Mr Houldsworth was a shareholder of the bank who had been fraudulently induced by the bank's directors and officials to purchase shares. Following the liquidation of the bank (an unlimited co-partnership registered under the UK Companies Act 1862) he brought an action against the bank on grounds of fraudulent misrepresentation. The House of Lords held that Mr Houldsworth was not permitted to retain his shares and to sue the bank for damages as recission of his contract was impossible after the bank had entered liquidation.[5]

Two late investors in the Company argued that *Houldsworth* did form part of the common law of the Cayman Islands and should be followed to prevent the Preferred Shareholders' misrepresentation claims from being admissible in the Company's liquidation. The petitioners argued that *Houldsworth* should be distinguished or that it forms no part of the laws of the Cayman Islands in the first place, given developments in the law since 1880 and in the context of today's company law.

Doyle J embarked on an extensive analysis of the decision in *Houldsworth*, subsequent judicial decisions (including in England,[6] Australia,[7] and Bermuda[8]) and a number of text-book commentaries. Doyle J acknowledged that it was difficult to discern the *ratio* of *Houldsworth*, that much has been written about it and that it had been subject to extensive criticism, being described as a decision that '*no doubt bears the stamp of its era*'.[9] The rule in *Houldsworth* was subsequently abrogated in the UK by section 111A of the Companies Act 1985,[10] but the Cayman Islands legislature did not enact similar legislation.

The Judge recognised *inter alia* that *Houldsworth* concerned an unlimited co-partnership whereas the Company was a limited liability company with shares which were fully paid up. This was also not a case where the investors were claiming money which they contracted to contribute to pay the debts and liabilities of the Company as in *Houldsworth*. However, Doyle J did not consider that he was able to distinguish *Houldsworth*, as the *ratio* of *Houldsworth* had been interpreted by subsequent decisions as applying to limited companies.[11]

Doyle J explored the impact of English precedent on the law of the Cayman Islands and provided a detailed analysis in relation to the position of *stare decisis*, *ratio decidendi* and *obiter dicta* early in his judgment. Following this, the Judge held that a number of avenues existed which allowed a judge of the Grand Court to refuse to follow an English court, even at appellate level.[12]

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[4] *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317.

[5] Following *Oakes v Turquand and Tennett v City of Glasgow Bank* (1867) LR 2 HL 325.

[6] *Soden v British & Commonwealth Holdings Plc* [1998] AC 298 (***Soden***).

[7] *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1; [2007] 3 LRC 462 (***Sons of Gwalia***). The effect of this decision was subsequently overturned by the Corporations Amendment (Sons of Gwalia) Act 2010.

[8] *Televest Ltd* [1995] Bda LR 71.

[9] *HQP Corporation Limited* at paragraph 144 citing *Sons of Gwalia* at paragraph 183.

[10] As inserted by the UK Companies Act 1989. That statutory provision is now contained in section 655 of the UK Companies Act 2006.

[11] See *Addlestone Linoleum Co* (1887) 37 Ch D 191 at pages 205-206 and *Soden*, Peter Gibson LJ and Lord Browne-Wilkinson.

[12] *HQP Corporation Limited*, paragraph 70.

Doyle J held '*...this is one of those rare cases where this court is justified, indeed obliged, to decline to follow an English decision*'.[13] Doyle J relied on the following reasons for not following *Houldsworth*:

> '*(1) it is arguably contrary to or adds an unjustifiable judicial restriction to the plain wording of a local statute (section 139 of the Companies Act);*[14]
>
> *(2) it has been abandoned by the UK Parliament, and has been heavily and persuasively criticised by others and not followed in the High Court of Australia and the Supreme Court in Bermuda at first instance;*
>
> *(3) its reasoning is inconsistent with contemporary company law;*
>
> *(4) it is an obsolete English common law decision which has ceased to be authoritative in England; and*
>
> *(5) it is simply not persuasive in the present context*'.

Accordingly, having declined to follow a decision of such high authority, Doyle J concluded that the Preferred Shareholders are not debarred by reason of *Houldsworth* from claiming for damages in the liquidation based upon misrepresentations made to them.

The Priority Issue

Doyle J was then tasked with determining how such claims, if admitted, would rank in a liquidation.

Section 49(g) of the Cayman Companies Act (2023 Revision) provides:

> '*no sum due to any member of a company in that person's character of a member by way of dividends, profits or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between the person and any other creditor not being a member of the company; but any such sum may be taken into account for the purposes of the final adjustment of the rights of the contributions amongst themselves.*' (emphasis added)

Doyle J found that section 49(g) would not apply to misrepresentation claims. The Preferred Shareholders' claim for damages was held not to be a debt due to the Preferred Shareholders in their capacity as members as any sum due from a successful misrepresentation claim would not arise under the statutory contract between the company and the members *inter se* constituted by the relevant statutory provision. Such a claim was held to arise from a tort independent from the statutory contract of membership. In reaching this finding, Doyle J found the reasoning of the High Court of Australia in *Sons of Gwalia Ltd v Margaretic*[15] more persuasive than the *obiter*, but arguably more authoritative, statements of Lord Browne-Wilkinson in the House of Lords decision, *Soden v British & Commonwealth Holdings Plc*.[16] As a consequence, the misrepresentation claims would not be subordinated as members' claims in the waterfall pursuant to section 49(g).

Doyle J also held that a waterfall of payments provided for in the Company's articles did not apply to subordinate claims for damages for misrepresentation by the Preferred Shareholders. The relevant provision in the articles was held to only apply to member debts and was not wide enough to cover debts arising from damages claims for misrepresentation.

Doyle J therefore directed that the admitted proofs of debt submitted by Preferred Shareholders for claims in misrepresentation against the Company rank as unsecured debts of the Company.

Conclusion

This is the first judgment in the Cayman Islands to undertake a detailed consideration of the rule in *Houldsworth*, which has been subject to much academic debate and judicial scrutiny in other

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[13] *HQP Corporation Limited*, paragraph 172.

[14] Section 139 of the Companies Act (2023 Revision) provides *inter alia* that '*All debts payable on a contingency and all claims against the company whether present or future, certain or contingent, ascertained or sounding only in damages, shall be admissible to proof against the company...*'. Doyle J considered that debts arising from claims for damages for misrepresentation fall within the wide wording of section 139 and that such statutory provision was '*untainted by Houldsworth*'.

[15] *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1; [2007] 3 LRC 462.

[16] *Soden v British & Commonwealth Holdings Plc* [1998] AC 298, page 325G.

jurisdictions. In fact, it is surprising that this issue has not arisen to date considering the active investment industry in the Cayman Islands.

This is a bold decision in many respects and is not the last that we expect to hear from the Cayman Islands judiciary on the applicability of the rule in *Houldsworth*. Mourant act in *the Matter of Direct Lending Income Feeder Fund, Ltd (In Official Liquidation)* FSD 108 of 2019. A judgment is soon expected to be delivered in this case that likewise addresses the applicability of the rule in *Houldsworth* to shareholder misrepresentation claims made against a company in liquidation and, if admitted, the resulting priority of payments. Given the importance of these decisions it is quite possible that they will be subject to further judicial consideration.

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