MARCH 2024

UPDATE

Houldsworth and *Direct Lending*: The saga continues

Update prepared by Simon Dickson, Laura Stone and David Ramsaran (Cayman)

With the handing down of Mr Justice Segal's decision in *The Matter of Direct Lending Income Fund*, the *Houldsworth* saga and the question of whether shareholder misrepresentation claims can be admitted in a liquidation continues.

Many will have waited for a bus only for two to come along at once. So it is in the Cayman Islands, with the ongoing saga as to whether a shareholder can make a claim for misrepresentation in a liquidation and, if so, where such a claim ranks in the order of priority. The rule in *Houldsworth* barring such claims has been in existence for over 140 years. However, two liquidations have, within weeks of each other, sought to overturn this longstanding rule.

In *HQP Corporation Limited* (***HQP***),[1] Mr Justice Doyle found that the rule in *Houldsworth* does not apply and that claims for misrepresentation by shareholders (the **Misrepresentation Claims**) should rank as ordinary non shareholder creditor claims (**Creditor Claims**). See our legal update on the *HQP* decision here.

In *The Matter of Direct Lending Income Feeder Fund* (***DLI***),[2] released some months after *HQP*, Mr Justice Segal has disagreed, finding that the rule in *Houldsworth* does apply and that shareholders may not make a claim for misrepresentation in a liquidation, where such a claim would compete with Creditor Claims. Given this finding, Mr Justice Segal also disagreed with Mr Justice Doyle as to the ranking of such claims, finding that a Misrepresentation Claim could not be a Creditor Claim, but instead would be subordinate and rank as a shareholder claim under section 49(g) of the Companies Act (2023 Revision) (the **Act**). Controversially, the Judge also found that a Misrepresentation Claim would rank *pari passu* with any redemption creditor claim, thereby displacing the previously held belief that a redemption creditor reigned supreme in the shareholder rankings.

Background

Direct Lending Income Feeder Fund, Ltd (the **Company**), was a feeder fund of DLI Capital, Inc. On 22 March 2019, the SEC charged the investment manager with a multi-year fraud, whereby it is alleged that Direct Lending deliberately overstated the value of loans by falsely reporting the borrower payment information. On 25 July 2019, the Grand Court made an order putting the Company into official liquidation. At the date of liquidation, aside from various Creditor Claims, the Company also had extensive redemption creditor claims, where the redemption request had been properly made but the proceeds not paid (**Redemption Creditors**). Given the alleged fraud, the question arose as to whether, in addition to these claims, other investors may have claims for misrepresentation against the Company in respect of their share subscriptions.

In order to resolve these issues the Court had to decide:

(a) Whether Misrepresentation Claims are provable in a liquidation (the ***Houldsworth* Issue**)?

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

[2] *The Matter of Direct Lending Income Feeder Fund* (Unreported, 13 March 2024, Segal J).

(b) If Misrepresentation Claims are provable, where such a claim would rank in the order of priority (the Priority Issue)?

The *Houldsworth* Issue

The rule in *Houldsworth* arises from a House of Lords decision which determined that shareholders with a misrepresentation claim are not entitled, after the commencement of a winding up, to rescind their subscription contracts and prove in the winding up for damages.[3] The rationale for this principle is that after a winding up, when a company's capital is to be fully available to meet all its debts and liabilities to creditors, a subscriber for shares cannot remove from the company the economic benefit of its original contribution to its capital.

On the question as to whether the rule was still applicable in the Cayman Islands, the Court found that it was. Contrary to Mr Justice Doyle's position in *HQP* that, *inter alia*, *Houldsworth*'s reasoning was inconsistent with contemporary company law and an obsolete English common law decision, the Court in *DLI* found that the rule had not been expressly abolished by legislative changes (as is the case in the United Kingdom) and therefore remains part of the common law.

As to the rule being contrary to contemporary company law and obsolete, the Court found that although the rules of modern-day company law have been liberalised since *Houldsworth* was determined, the principles that give rise to the rule remain applicable, namely that the capital of a company should be maintained for the benefit of creditors, ahead of its shareholders.

However, the Court did not see the rule as creating what had commonly been understood to be a blanket exception to Misrepresentation Claims. Instead, the Court found that the rule, properly understood, only precludes a shareholder from proving for damages for misrepresentation in a winding up, in competition with Creditor Claims. Once such Creditor Claims have been proved and provided for any bar is lifted.

The Court reached this position by seeking to align the common law rules with the statutory priority of payments. The argument goes that the need for the protection of capital for the benefit of creditors falls away if Misrepresentation Claims are subordinated, the simple logic being that ordinary creditors will be paid out of the company's capital first after which capital protection is irrelevant. By making this finding, the Court has, from a practical perspective, sought to dilute if not negate the effect of the rule in *Houldsworth*.

The Priority Issue

In order for the rule in *Houldsworth* to be diluted, the Court had to be satisfied that a Misrepresentation Claim was a '*claim by a member, in their character as a member*' in accordance with section 49(g) of the Act and, accordingly, subordinate to Creditor Claims.

Whilst this may seem an obvious point, the decision in *HQP* threw the position into doubt. Mr Justice Doyle found that Misrepresentation Claims in respect of the subscription for shares were, in fact, ordinary Creditor Claims. The finding was made on the basis that the misrepresentation took place before the shareholder had entered into the statutory contract of membership.

Departing from the decision of Mr Justice Doyle, the Judge followed the approach taken by Lord Browne-Wilkinson in the case of *Soden*[4] when interpreting an identical provision to section 49(g) under English Law. In *Soden*, Lord Browne-Wilkinson found that the rationale of the equivalent section was *'to ensure that the rights of members as such do not compete with the rights of the general body of creditors'*[5] and to maintain the capital maintenance rules. Given this high authority, the Judge found that claims of shareholders relating to or derived from their contribution of capital cannot compete with and must rank after the claims of non-member creditors. Accordingly, Misrepresentation Claims must be characterised and treated as claims relating to or derived from a shareholders' contribution of capital, and not as a claim independent of the statutory contract.

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

[4] *Soden v British & Commonwealth Holdings Plc* [1998] AC 298.

[5] *Soden*, at page 299C.

Priority as against Redemption Creditors

In deciding that the Misrepresentation Claims fall under section 49(g) of the Act, and are therefore shareholder claims, the court was left to consider the relative priority as between the Misrepresentation Claims and the Redemption Creditors.

It was not in dispute that the claims by Redemption Creditors are claims by former members of the Company, and therefore are subordinated to unsecured Creditor Claims by operation of section 49(g). However, it was submitted by the Redemption Creditors that redemption claims rank ahead of all other shareholders who have claims under section 49(g), including Misrepresentation Claims. This position was put (i) on the basis of the statutory order of priority under section 37(7)(a) and (b) of the Act, which provides that shares which are liable to be redeemed but have not been redeemed should be paid after all other debts and liabilities of the company *other* than any debts and liabilities due to a member in the character as such, and (ii) on the decisions in *Re Herald Fund SPC (in official liquidation)*[6] dealing with these provisions.

The slight wrinkle in this case was that the Redemption Creditors had actually been redeemed and so were not holding shares that were liable to be redeemed under section 37(7)(a). However, the argument went that if the legislature intended that those holding shares liable to be redeemed should be paid in accordance with section 37(7)(b) and hence ahead of other members, a shareholder who has been fully redeemed must be treated the same or in priority.

The Court entered into a complicated analysis of the respective priorities of Redemption Creditors and shareholders who are liable to be redeemed and fall within section 37(7) of the Act. The Court found, albeit obiter, that these two classes of shareholder would rank *pari passu*.

However, on the key point as to where Redemption Creditors would rank as against Misrepresentation Claims, the Court found that under section 49(g) there was no basis upon which to elevate redemption claims of any nature above other shareholder claims.

This aspect of the decision is somewhat surprising. Despite what appears to have been the clear legislative intent of section 37(7)(b), that shareholders liable to be redeemed should be paid in advance of payments to other shareholders, the Court took a different view. In interpreting this section and the decisions in *Herald*, the Court found that section 37(7)(b) did nothing more than put Redemption Creditors below ordinary creditors, but was silent as to how such claims ranked as against other member claims. That being so the Court considered that it had to look to section 49(g) which was silent on the point. The Court took the view that accordingly, it had no power to conclude anything other than the claims should all rank *pari passu*.

Conclusion

This decision leads to further uncertainty as to how Misrepresentation Claims should be treated and what the order of priority should be. As the law stands, one Court says *Houldsworth* doesn't apply, the other that it does, but only after creditors have been paid. One Court says that Misrepresentation Claims are ordinary Creditor Claims, the other, on the basis of high authority, that such claims are surely shareholder claims. On the order of priority of Redemption Creditors, whilst *HQP* did not deal with it, the decision of Mr Justice Segal reopens the anxious debate as to priority and the proper interpretation of section 37(7) and section 49(g). In all, the law is now in a state of flux. The Court of Appeal beckons as the buses continue to charge across the legal landscape.

Mourant acts for Eiffel eCapital US Fund, as a Redemption Creditor in these proceedings.

[6] [2016] 2 CILR 330 and [2017] 2 CILR 75.

Contacts

Simon Dickson
Partner
Mourant Ozannes (Cayman) LLP
+1 345 814 9110
simon.dickson@mourant.com

Laura Stone
Senior Associate
Mourant Ozannes (Cayman) LLP
+1 345 814 9121
laura.stone@mourant.com

David Ramsaran
Associate
Mourant Ozannes (Cayman) LLP
+1 345 814 9133
david.ramsaran@mourant.com

2021934/89881279/1