

UPDATE

# Rectification and distribution of fund interests and assets

Update prepared by Peter Hayden (Managing Partner, Cayman Islands) and Rocco Cecere (Counsel, Cayman Islands)

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The recent judgment of the Cayman Islands Court of Appeal (the CICA) in the representative proceedings between Primeo Fund (in official liquidation) (Primeo) and the Additional Liquidator (Additional Liquidator) of Herald Fund SPC (in official liquidation) (Herald) considers and addresses how distributions should be made to investors from a Cayman Islands' fund.

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Importantly, the CICA has rejected the suggestion that a liquidator can use the statutory power allowing rectification of the register of members to override investors' legal rights. In the current case, the Additional Liquidator argued that he could use the power of rectification to impose on investors an outcome that he regarded as being fair, without reference to their legal rights. Herald was a fund impacted by the Madoff fraud and the Additional Liquidator wanted to try to mirror the approach to distributions being adopted by the Madoff Trustee in New York pursuant to US law, which involves making them on a net cash basis, rather than the well-established position in the Cayman Islands that distributions should be made to members by reference to their shareholdings as they exist at the commencement of liquidation.

## The Legislative Provisions

At issue in the case were section 112 (2) of the Companies Law (as amended) (**Section 112**) and Order 12, rule 2 (**Rule 2**) of the Companies Winding Up Rules (**CWR**) which are the main provisions empowering a liquidator to rectify the register of a solvent company.

Section 112 provides that in the case of a solvent liquidation of a company which has issued redeemable shares at prices based upon its net asset value (**NAV**) from time to time, the liquidator shall have the power to settle and, if necessary, rectify the company's register of members, thereby adjusting the rights of members amongst themselves.

In turn, Rule 2 provides that a liquidator is required to rectify the company's register if the company (a) is or will become solvent, (b) has issued or redeemed redeemable shares at prices based upon a mis-stated NAV which is not binding upon the company and its members by reason of fraud or default, and (c) has issued or redeemed an excessive or inadequate number of shares as a result.

## The Grand Court Decision

At first instance, the Additional Liquidator argued that he was empowered, under both Section 112 and Rule 2, to rectify Herald's register so as to reach a position which was fair and just as between shareholders.

With respect to Rule 2, the Additional Liquidator argued that he was obligated to rectify Herald's register as each of the requirements of Rule 2 were met. In particular, he argued that, because Bernard L Madoff Investment Securities LLC (**BLMIS**) was a fraud, any NAV issued by Herald was not binding by reason of fraud. The Additional Liquidator did not allege that there was any fraudulent conduct on the part of Herald which would render the NAVs not binding as a matter of contract, but rather said that they were not binding because, with the benefit of hindsight, it could be seen that the NAVs were inaccurate as a result of

being based on valuation statements provided to Herald by BLMIS. Alternatively, he also argued that breaches of duty by Herald's administrator (HSSL) (which had the delegated function of calculating NAVs) could be attributed to Herald's directors such that the NAVs were not binding.

With respect to Section 112, the Additional Liquidator argued that it provided a free standing basis upon which he could rectify Herald's register, which was broader than Rule 2. He claimed that Section 112 gave a liquidator the power to override the contractually binding nature of NAVs in circumstances where he considered it was necessary to do so to achieve justice between shareholders affected by BLMIS' fraud.

Primeo argued that the term rectification carries its normal, well understood meaning and only allowed a register of members to be amended to properly record and reflect shareholders' existing legal rights to shares.

Primeo submitted that Section 112 was an enabling provision which provided a liquidator the power to rectify while Rule 2, consistent with the role of secondary legislation, set out the circumstances in which that power can be used. Rule 2 required that there was some fraud or default on the part of Herald which rendered the NAVs not binding.

### Finding regarding Section 112 and Rule 2

At first instance, the Grand Court agreed with Primeo's construction of Rule 2. Jones J held that the power to rectify under Rule 2 could only be exercised if Herald's NAVs were not binding upon it and its members as a result of a fraud or default attributable to Herald itself which had the effect of vitiating the contract with its members. Based on the evidence, there was no such conduct. In particular, the Grand Court noted that Article 18(f) of Herald's articles of association (**Articles**) expressly stated that NAVs were binding on all persons if Herald's directors acted bona fide in the best interests of the company. As the Additional Liquidator had not alleged that the Herald directors acted in bad faith, notwithstanding the Additional Liquidator's attribution argument, the NAVs were binding and the requirements of Rule 2 had not been met.

However, Jones J found that the Additional Liquidator was empowered to rectify the register pursuant to Section 112. He considered that Section 112 was a free standing, discretionary power to rectify which was broader in scope than Rule 2 and was available to a liquidator where it was necessary to do justice amongst shareholders. In this context, rectification was not concerned with reflecting a shareholder's contractual rights but was rather to ensure that the register reflected the position as if all the relevant subscriptions and redemptions had been transacted at a true NAV.

### Finding regarding rectification methodology

Given his findings regarding Section 112, Jones J also had to determine how Herald's register should be rectified. The Additional Liquidator argued that he should be permitted to rectify Herald's register of members so that distributions could be made on a net cash basis. In particular, the Additional Liquidator argued for the Rising Tide Method, a variant of the net cash methodology, which takes into account recoveries already made by investors through previous redemptions and seeks to equalise the recoveries across all investors.

Primeo argued that, if the Additional Liquidator was allowed to rectify, it could only be done by reference to the shareholding that a shareholder would have had if an accurate NAV had been applied as at each subscription and redemption date. If that was not possible, the Additional Liquidator could not determine the true NAV and could not rectify.

Somewhat surprisingly, Jones J rejected the arguments of both parties on the method of distribution and in his judgment created a third method, which had not been argued at the hearing. Jones J rejected the Additional Liquidator's arguments finding that adopting a net cash methodology would be inconsistent with the statutory distribution mechanism required by section 140(1) of the Law. However, Jones J said that, if it was impractical or not cost effective to calculate the true NAV for each relevant valuation date, a liquidator was permitted to determine and apply another method which the liquidator believed was both cost-effective and fair and equitable as between shareholders. Jones J found that the appropriate methodology in this case was to assume that all subscriptions and redemptions were carried out at Herald's initial subscription price, rather than the NAV prevailing at the time. Jones J considered that this would result in a share register which put an equal value on the funds invested by all subscribers over the relevant period and remove the impact of any fictitious profits.

## The CICA Decision

Both parties appealed with Primeo appealing the finding with respect to the scope of Section 112, the Additional Liquidator appealing the finding with respect to Rule 2 and both parties appealing the findings with respect to the appropriate rectification methodology.

In a unanimous decision, the CICA allowed Primeo's appeal in its entirety and dismissed that of the Additional Liquidator in its entirety.

On the issue of Rule 2, the CICA agreed with Primeo's submissions finding that Rule 2 contemplates the power of rectification being exercised by a liquidator where the NAVs are not binding due to the presence of some internal fraud or default which has the effect of vitiating the underlying contractual arrangements between a company and its shareholders. In reaching this conclusion, the CICA rejected the Additional Liquidator's contention that any NAV affected by fraud or default was not binding as this was wholly contrary to the well-established policy of contractual certainty. In particular, the CICA found persuasive the dicta of the Privy Council in *Fairfield Sentry v Migani* [2014] UKPC 9 which recognised the importance of certainty with respect to NAVs.

On the issue of the scope of Section 112, the CICA also agreed with Primeo's submission, relying upon the Privy Council decision in *Nilon Ltd v Royal Westminster Investments SA* (2015) 2 BCLC 1, that the term rectify, as used in Section 112, bears the same meaning as in other provisions within the Law and in general law, namely it is simply a mechanism to give effect to a shareholder's existing legal rights. The CICA found that the purpose of Section 112 is to enable a register to be rectified *in order to declare the rights which have accrued to a member in accordance with his contract and the general law governing that contract*.

Importantly, Section 112 does not confer a discretionary power upon a liquidator to override the legal rights of members. Section 112 is therefore only available in circumstances where the NAVs are not binding.

As the Additional Liquidator had failed to demonstrate that the NAVs were not contractually binding, and in light of Article 18(f), the CICA found that the Additional Liquidator could not use either Section 112 or Rule 2 to rectify Herald's register.

Given these findings, the CICA did not need to address Jones J's ruling on the rectification methodology.

## Commentary

The CICA considered that the broader concepts of justice and fairness did not require the removal of the impact of the fraud but instead required the contractual bargain struck between the fund and its investors to be upheld. This approach is entirely consistent with the dicta of the Privy Council in *Fairfield Sentry*.

Peter Hayden, Rocco Cecere and Christopher Levers acted for Primeo, instructing Tom Smith QC of South Square chambers.

## Contacts

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