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ARTICLE

Restoration of the 'Redemption Creditor' in the Cayman Islands; However, the Tree May Not Lie Where It Falls

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Introduction

A recent judgment of the Cayman Islands Court of Appeal[1] ('CICA') has provided a welcome degree of certainty for investors and insolvency practitioners alike with respect to the priority to be afforded to investors' claims for unpaid redemption proceeds in the winding up of Cayman Islands investment funds. The judgment has, however, given rise to a suggestion that the relevant part of the legislation may operate such as to allow investors, in certain circumstances, to convert themselves from shareholders to creditors after the commencement of a winding up.

The CICA decision is one of the most recent in the ongoing liquidation proceedings of Herald Fund SPC ('Herald'). Herald was, in terms of its constituent documents at least, a fairly typical Cayman Islands domiciled open-ended mutual fund, often referred to as a 'hedge fund' (the Cayman Islands remaining the most popular hedge fund jurisdiction in terms of both number of registered entities and total assets under management). However, as explained below, Herald's sole investment turned out to be a substantial investment in the Madoff Ponzi scheme and Herald ultimately ended up in official liquidation in the Cayman Islands.

As with most developed common law jurisdictions, the legal framework in the Cayman Islands for winding up insolvent companies has long been the domain of statute, codifying common law principles developed over two centuries of jurisprudence. Prior to the first instance decision which was appealed to the CICA, the Companies Law (2013 Revision) (as amended) (the 'Companies Law') and its subordinate rules, The Companies Winding Up Rules 2008 (as amended) (the 'CWR'), had been considered by many practitioners to provide a relatively clear mechanism for determining the enforceability and priority of creditor claims in a Cayman Islands liquidation, drawing a clear distinction for the purposes of priority in the liquidation between ordinary unsecured third party or 'outside' creditors (e.g. trade creditors and service providers) and those creditors whose claims arose in their capacity as members, for example, redeeming shareholders (i.e. those shareholders who sought to redeem all or part of their investment, but had not been paid prior to the commencement of the winding up - what has become known, perhaps colloquially, as a 'redemption creditor'). This distinction was temporarily displaced as a result of the first instance decision of the Grand Court of the Cayman Islands ('Grand Court'), with clarity being provided by the CICA – effectively confirming and restoring a common law principle that has existed for over 100 years.

This aspect of the proceedings involves an important point of statutory construction, namely how section 37(7) of the Companies Law operates in the factual context of Herald which involved claims to significant unpaid redemption proceeds which were sought to be enforced several years after the discovery of the Ponzi scheme and which with the benefit of hindsight were clearly based on a wholly fictitious NAV. The outcome of the proceedings is highly material to Herald's various categories of stakeholders (the redemption claims, if valid, being valued at almost USD 200m). The issue is one that has rarely confronted the Grand Court in any detail and certainly this was the first time it had been considered at appellate level.

The Additional Liquidator of Herald[2] has subsequently issued a further appeal from the decision of the CICA to the ultimate appellate court of the Cayman Islands, the Judicial Committee of the Privy Council ('Privy Council').

Background

Herald was a segregated portfolio company incorporated in the Cayman Islands and was one of the largest

Notes

1 *Michael Pearson (in his capacity as Additional Liquidator of Herald Fund SPC (in Official Liquidation)) v Primeo Fund (in Official Liquidation)*, unreported, 19 July 2016.

2 An additional official liquidator was appointed in addition to two principal joint official liquidators for the purpose of dealing with a number of discrete issues in the liquidation.

so-called feeder funds into the Madoff Ponzi scheme. Prior to the discovery of Madoff's fraud in December 2008, a significant number of investors in Herald had submitted redemption requests for a trade date of 1 December 2008 (the 'December Redeemers'), with payment specified under the constituent documents to be made generally within 20 business days after that date. Under Herald's Articles of Association ('Articles'), the trade date was specified to be the 'Redemption Day', with payment of redemption proceeds and removal from the share register to be completed thereafter – a very common, if not typical, mechanism in the articles of a Cayman Islands mutual fund.

Shortly after Madoff was arrested on 11 December 2008, Herald's directors convened a board meeting on 12 December 2008 at which they passed a resolution suspending the calculation of NAV, subscriptions, redemptions and, importantly, the payment of redemption proceeds[3] – in excess of USD 190 million of which had not yet been paid to the December Redeemers. This suspension took place after the 1 December 2008 Redemption Day had passed (the Directors being wholly unaware at the time that Herald's sole asset was about to be exposed as an interest in the world's largest Ponzi scheme).

Following the presentation of a winding up petition by the largest December Redeemer, Primeo Fund (in Official Liquidation) ('Primeo')[4], Herald was placed into official liquidation in July 2013. Primeo and various other December Redeemers subsequently filed proofs of debt in the ordinary way in respect of their claims for unpaid redemption proceeds.

Rather than adjudicating those proofs of debt in accordance with the procedure set out in the Companies Law and the CWR, the Additional Liquidator of Herald sought directions from the Grand Court as to the enforceability of those 'redemption creditor' claims under section 37(7)(a) of the Companies Law (the 'December Redeemer Issue').

Section 37(7) provides:

> '(a) Where a company is being wound up and, at the commencement of the winding up, any of its shares which are or are liable to be redeemed have not been redeemed or which the company has agreed to purchase have not been purchased, the terms of redemption or purchase may be enforced against the company, and when shares are redeemed or purchased under this subsection they shall be treated as cancelled:
>
> Provided that this paragraph shall not apply if –
>
> (i) the terms of redemption or purchase provided for the redemption or purchase to take place at a date later than the date of the commencement of the winding up; or
>
> (ii) during the period beginning with the date on which the redemption or purchase was to have taken place and ending with the commencement of the winding up the company could not, at any time, have lawfully made a distribution equal in value to the price at which the shares were to have been redeemed or purchased.
>
> There shall be paid in priority to any amount which the company is liable by virtue of paragraph (a) to pay in respect of any shares-
>
> (i) all other debts and liabilities of the company (other than any due to members in their character as such); and
>
> (ii) if other shares carry rights whether as to capital or as to income which are preferred as to the rights as to capital attaching to the first mentioned shares, any amount due in satisfaction of those preferred rights,
>
> but subject to that, any such amount shall be paid in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members.'

Utilising a mechanism available under the CWR, the Grand Court made orders for the determination of the December Redeemer Issue through inter partes proceedings within Herald's liquidation[5], with Primeo appointed as class representative for the December Redeemers and the Additional Liquidator appointed as class representative for Herald's remaining stakeholders.[6]

First instance decision – the apparent death of the 'redemption creditor'

At the first instance hearing in the Grand Court in June 2015, Primeo contended that the December Redeemers

Notes

3 A second resolution was passed on 24 December 2008 which, inter alia, suspended the payment of outstanding redemption requests (prior to the date upon which Herald would otherwise have been contractually obligated to pay those redemption requests). In any event, as Herald's sole asset (other than a limited amount of cash for operating expenses) was its interest in BLMIS, Herald was not in a position to pay those redemption requests at the time (or indeed for many years thereafter).

4 This was a contributory's 'just and equitable' petition, rather than a creditor's petition.

5 Given the number of common issues between the Herald and Primeo liquidations, the Grand Court also directed, by way of a 'parallel order', that any matters determined in Herald's 'representative proceedings' would be similarly binding in Primeo's liquidation.

6 The Grand Court also made orders for the substantive determination of a number of other issues in the same 'representative proceedings'; however, these issues are unrelated to the December Redeemer Issue.

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fell outside the scope of section 37(7) of the Companies Law in circumstances where the December Redeemers had already 'redeemed' their shares pursuant to the terms of the Articles on 1 December 2008 and those shares were not therefore shares which 'are or are liable to be redeemed but have not been redeemed' under section 37(7)(a) of the Companies Law. Primeo also sought a declaration that the December Redeemers had a creditor claim ranking pari passu with external or third party creditors.

In contending that the December Redeemers fell outside the scope of section 37(7) of the Companies Law, Primeo placed great reliance on the Privy Council's decision in *Strategic Turnaround Master Partnership Limited v Culross Global SPC Limited* [2010] (2) CILR 364. In that case the Privy Council held (in the context of whether *Culross* had become a creditor with locus standi to petition for the winding up of *Strategic Turnaround*) that 'redemption' occurs at the date specified in a company's articles of association 'by reference to which the redemption price payable is crystallised and from which the amount payable is deemed to be a liability [with] the remittance of "redemption proceeds" treated as a matter of supplementary procedure'[7]. Primeo relied on that statement in support of its argument that the December Redeemers had already 'redeemed' their shares as a matter of law on 1 December 2008 and those shares were not therefore shares which 'are or are liable to be redeemed but have not been redeemed' under section 37(7)(a) of the Companies Law.

Acknowledging that the legislative drafting of section 37(7) was not as clearly expressed as it could have been, the Additional Liquidator took the position that, notwithstanding Herald's articles focused on a redemption date as at the redemption day and prior to payment, the Articles were not determinative of the meaning of 'redeemed' for the purposes of the statute. When shares were redeemed for the purposes of the Articles was immaterial when determining whether or not a 'redemption creditor' claim was enforceable in a liquidation in circumstances where section 37 of the Companies Law as a whole established a complete code for the issuance and redemption of shares and, in that context, the terms 'redemption' and 'redeemed' in the statute (and in section 37(7) in particular) were concerned with the payment of redemption proceeds. After all, what other term of redemption would a shareholder realistically go to the time and expense of enforcing?

In determining the December Redeemer Issue in favour of Primeo, the Grand Court found that the December Redeemers had 'redeemed' their shares on 1 December 2008 and, accordingly, fell outside the operation of section 37(7) of the Companies Law altogether.

As a result, it seemed that as a consequence of the Grand Court's decision, 'redemption creditors' were entitled to prove in a winding up as creditors, with their claims ranking pari passu with the claims of ordinary third party or 'outside' creditors[8] – a significant departure from the previously accepted position in the Cayman Islands and, indeed, the long-standing position at common law, which had been recognised in the jurisdiction in many cases and as recently as November 2014 in *In re Palm Beach Offshore Ltd (In Official Liquidation)* FSD 38 of 2009 (unreported, 25 November 2014, Jones J).

The Additional Liquidator appealed the Grand Court's ruling.

The principle itself

The principle that 'outside' creditors should stand in a different position to those who have given notice of an intention to withdraw all or part of their investment can be traced back to a line of Victorian era authorities arising in the context of building societies.[9] The principle is a simple one: notwithstanding that notice of an intention to withdraw has been given, that claim is qua shareholder and not based upon rights as an 'outside' creditor. It follows that a shareholder (even a 'shareholder creditor') should not share pari passu with 'outside' creditors where there are insufficient funds for the payment of 'outside' creditors in full. It is trite law that shareholders are entitled to share in the surplus after all of a company's debts have been paid. Just because a shareholder has given notice of an intention to withdraw all or part of his investment, he should not be elevated to a status which allows him to share rateably and compete with 'outside' creditors in an insolvent winding up. Instead, his claim would be subordinated to those of 'outside' creditors, but paid in priority to those shareholders (who had not given notice to redeem) with whom he has a legal relationship inter se pursuant to the Articles, on the basis that he had given such notice in accordance with the governing documents.

The position at common law was put succinctly by the Eastern Caribbean Court of Appeal in its decision in *Somers Dublin Ltd and Ors v Monarch Pointe Fund Limited* [2013] ECSC JO311-10:[10]

Notes

7 [2010] (2) CILR 364 at [20].
8 As the CICA pointed out, this was not dealt with expressly in the first instance judgment.
9 See for example *In re Blackburn and District Benefit Building Society; Walton v Edge and Others* (1884) L.R. Vol. X H.L. (E) 33.
10 It should be noted that the British Virgin Islands has its own bespoke statutory regime which materially alters the common law position.

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> 'The words "may not claim in the liquidation" in section 197 must refer to claiming as an ordinary unsecured creditor. It reflects the old common law legal principle that redeemed members are deferred creditors, postponed behind ordinary unsecured creditors. As deferred creditors, their claims are "… to be taken into account for the purposes of the final adjustment of the rights of members and, if appropriate, past members between themselves."
>
> This interpretation is in keeping with long-standing rules of priority on a liquidation of a company. There is an analogy with the position of a "depositor" in an English building society. The word "depositor" is a misnomer, since persons who become members of the building society as a result of making a deposit are, while the deposit lasts, members and not creditors. However, once they give notice to withdraw their "deposit" and before payment, the withdrawing member's status changes. His status as a member or past member depends on the terms of membership, so that, if, e.g., termination of membership is subject to a period of notice and is not immediate, he remains a member, but in other cases he becomes a past member. In either case, he ranks as a deferred creditor, ranking behind outside creditors, but having priority ahead of continuing members.'[11]

CICA decision – the restoration of the 'redemption creditor'

Whilst the CICA affirmed the Grand Court's decision, finding that, as a matter of construction, section 37(7)(a) of the Companies Law does not apply to the claims of December Redeemers in circumstances where, at the commencement of the winding up, the relevant redeemable shares had been 'redeemed' in accordance with the terms of Herald's Articles, notwithstanding that payment had not been made and was not due to be paid at that time, the CICA rejected Primeo's contention that the claims of the December Redeemers rank pari passu with the claims of ordinary third party or 'outside' creditors.

Applying *Strategic Turnaround* principles, the CICA found that the December Redeemers were 'contingent creditors' who had, as a result of having 'redeemed' the relevant shares in accordance with the terms of the Articles prior to the commencement of the liquidation, divested themselves of their rights as shareholders, meaning that they had provable claims under section 139(1) of the Companies Law without the need for a specific enactment in the nature of section 37(7)(a). However, although the December Redeemers had ceased to be members, the CICA held that their claims were founded upon the statutory contract of membership and were therefore, by reason of the operation of section 49(g) of the Companies Law, subordinated to the claims of Herald's ordinary third party creditors consistent with the common law principle.

Section 49(g) of the Companies Law provides:

> 'In the event of a company being wound up every present and past member of such company shall be liable to contribute to the assets of the company to an amount sufficient for payment of the debts and liabilities of the company, and the costs, charges and expenses of the winding up and for the payment of such sums as may be required for the adjustment of the rights of the contributories amongst themselves:
>
> Provided that –
>
> …
>
> (g) no sum due to any member in his 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 himself 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 contributories amongst themselves.'

The restoration or re-enforcement of the common law principle that claims founded on the statutory contract must be subordinated to those of ordinary third party or 'outside' creditors appears to have been put beyond doubt by the CICA in its attempt to find a coherent construction for the operation of section 37(7)(a).

The CICA expressed the view that section 37(7)(a) applies where, at the commencement of a company's winding up, a holder of redeemable shares has 'an accrued right of redemption', but there has been no redemption because the steps required for 'redemption' to occur under the relevant articles of association have not been completed. Whilst the CICA's construction appears to give rise to a potential unintended consequence which is discussed further below, it nevertheless preserves the operation of section 37(7)(b) of the Companies Law (set out above), which in these authors' view, is a deliberate codification of the common law principle specifically intended to be applicable to the claims of 'redemption creditors' in the context of a winding up of a Cayman Islands mutual fund.

The tree may not lie where it falls

Whilst the CICA did not specify precisely what an 'accrued right of redemption' means, the authors consider

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11 [2013] ECSC JO311-10 at [22] and [23].

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that an accrued right of redemption likely arises where a shareholder has served a valid notice under the relevant articles of association, but 'redemption' has not occurred because all the steps (or the notice period) required for 'redemption' to occur under the relevant articles of association have not been completed (meaning, amongst other things, that no payment of redemption proceeds has been made).

This construction appears on its face to create tension with respect to the well-established principle of insolvency law that claims are ascertained as at the date of the commencement of the winding up and the distribution of assets are treated as notionally taking place simultaneously on the date of the winding up order. As stated by Selwyn LJ in *In re Humber Ironworks and Shipbuilding Co.* (1868-69) L.R. 4 Ch. App. 643, 646-647:

> 'I think the tree must lie as it falls; that it must be ascertained what are the debts as they exist at the date of the winding-up, and that all dividends in the case of an insolvent estate must be declared in respect of the debts so ascertained.'

Plainly, where an investor has served a valid redemption notice but has not 'redeemed' in accordance with the terms of the relevant articles of association as at the commencement of the winding up, he does not, as a matter of contract, have an enforceable debt or right to payment in the liquidation.

If this construction of 37(7)(a) is correct, the CICA appears to have given the legislation the perhaps unintended effect of allowing investors, in certain circumstances (that is, satisfaction of the provisos in section 37(7)(a)(i)[12] and (ii)), to convert themselves from shareholders to 'redemption creditors' after the commencement of a winding up.

Conclusion

Whilst the CICA's decision provides clarity that claims for the payment of redemption proceeds in a winding up (and, indeed, all claims founded upon the statutory contract of membership) will always rank behind ordinary third party or 'outside' creditors, the CICA also appears to have suggested that redeeming investors who do not have enforceable contractual claims outside liquidation may, in a liquidation, be able to convert themselves from member to creditor – a position which is seemingly at odds with a long standing principle of insolvency law and which the legislature does not expressly appear to have intended to displace. It is anticipated that the Privy Council will consider this point as, on the facts of Herald, there is a significant class of stakeholders who submitted redemption requests after 1 December 2008 but before the suspension of redemptions was implemented. On one view at least, those stakeholders may have 'an accrued right of redemption' (subject to the operation of provisos (i) and (ii)) which, if enforceable, would on the current state of the law rank pari passu with the December Redeemers but ahead of those shareholders who took no steps to redeem prior to liquidation.

Regardless of the ultimate outcome of the Privy Council appeal in this matter, further clarification is required – either by the Privy Council itself or by way of legislative reform.

Matthew Goucke and Chris Keefe act for the Additional Liquidator of Herald.[13]

Notes

12 Assuming that the proviso in section 37(7)(a)(i) is actually possible.

13 Together with Leading Counsel, Lord Goldsmith QC PC and Francis Tregear QC.

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International Corporate Rescue

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