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ARTICLE

'The Path to Redemption Is Not Always Smooth': Unfortunate Consequences for Unredeemed Investors in the Cayman Islands

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Introduction

A recent judgment of the Judicial Committee of the Privy Council[1] ('Privy Council' or 'Board'), the ultimate appellate court of the Cayman Islands, has provided certainty for investors and insolvency practitioners alike with respect to the enforceability and 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 rise to commercially unfortunate results in that the effects of a mis-stated NAV now appear capable of being perpetuated in a winding up, regardless of the fund's ability (or inability as the case may be) to lawfully make payment of redemption proceeds prior to the commencement of liquidation.

The Privy Council decision is 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'. 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.

This aspect of the proceedings involved 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 mis-stated NAV. The outcome of the proceedings is highly material to Herald's various categories of stakeholders (the redemption claims 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 the highest appellate level.

Background

Herald was a segregated portfolio company incorporated in the Cayman Islands and was one of the largest 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 (the 'Suspension').[2] 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'),[3] Herald was placed into official liquidation in July 2013. On 24 November 2014, the Additional Liquidator of Herald sought directions from the Grand Court as to the enforceability of

Notes

1 Michael Pearson (in his capacity as Additional Liquidator of *Herald Fund SPC (in Official Liquidation)) v Primeo Fund (in Official Liquidation)* [2017] UKPC 19, Lord Mance giving the opinion.

2 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).

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

those 'redemption creditor' claims under section 37(7)(a) of the Companies Law (2013 Revision) ('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.
>
> (b) 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 Companies Winding Up Rules 2008 (as amended), the Grand Court of the Cayman Islands ('Grand Court') made orders for the determination of the December Redeemer Issue through inter partes proceedings within Herald's liquidation,[4] with Primeo appointed as class representative for the December Redeemers and the Additional Liquidator appointed as class representative for Herald's remaining stakeholders.[5]

Following the ruling of the Cayman Islands Court of Appeal ('CICA'), where the CICA found that section 37(7) applied to a holder of redeemable shares with an 'an accrued right of redemption' (but did not specify precisely what that meant), two further potential classes of investors with an interest in the outcome of the proceedings emerged; those who had submitted valid redemption requests in the liquidation of Herald prior to the Suspension (the 'Late Redeemers') and those who had purported to submit redemption requests after the Suspension (the 'Later Redeemers'). Each of these classes was previously part of the Additional Liquidator's representative class in circumstances where neither class had 'redeemed' in accordance with the provisions of Herald's Articles. The Grand Court subsequently made orders appointing a class representative for each of the Late and Later Redeemers, with each representative granted leave by the Privy Council to intervene in the Additional Liquidator's appeal.

The decisions of the Courts below were dealt with in some detail in our previous article 'Restoration of the 'Redemption Creditor' in the Cayman Islands; However, the Tree May Not Lie Where It Falls'.[6]

Privy Council decision

Affirming the rulings of the Grand Court and the CICA (notwithstanding the somewhat different approaches the Courts below had, regrettably, taken), the Board remarked that 'the path to redemption is not always smooth', but that 'redemption' nonetheless occurs on surrender of the status of shareholder, which is entirely a function of the terms of the contract of membership between a company and its members inter se – expressing the freedom that shareholders and a company have to shape their relationship as a matter of contract as regards redemption or purchase of a company's shares. Referring to its earlier judgment in *Strategic Turnaround*, the Privy Council found the Additional Liquidator's interpretation improbable on the basis that the Companies Law should have intended to impose, even in the context of a winding up, a completely different meaning of redemption, without express language to that effect.

The Privy Council did not accept the Additional Liquidator's argument that 'redemption' ought to have an autonomous statutory meaning (being the completion of the entire process of redemption, including payment). What follows is the result that the enforceability of a

Notes

4 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.

5 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.

6 (2017) 14:1 *International Corporate Rescue* 51.

claim for unpaid redemption proceeds in the Cayman Islands is now entirely dependent on how 'redemption' is defined under the relevant articles of association of a particular company. Regrettably, the Privy Council did not address in its judgment a number of the arguments advanced by the Additional Liquidator in support of a consistent statutory definition.

The Additional Liquidator was however successful in opposing the claims of the Late Redeemers who asserted that they had enforceable claims arising under section 37(7) of the Companies Law.[7] The Privy Council rightly rejected these claims on the basis that the Suspension meant that the terms of redemption provided for it to take place at a date *later* than the commencement of the winding up (in circumstances where Herald's directors never lifted the Suspension prior to that date).

In terms of the application of section 37(7), the Board in its judgment did not refer to the various academic texts cited by the Additional Liquidator which suggested that redemption for the purposes of the section meant the completion of the entire process of redemption, including payment, and instead found that section 37(7) envisages situations where shares are or are liable to be redeemed or purchased, but where a company had for any reason wrongly failed to take steps necessary to enable the redemption or purchase at the applicable date in accordance with the terms of the relevant articles of association. The Board found that section 37(7) had the effect of elevating a shareholder to a priority 'it did not otherwise enjoy'. Put another way, the Board appears to have departed somewhat from the long-standing insolvency principle that 'the tree must lie where it falls'[8] by seemingly allowing investors, in certain circumstances (that is, satisfaction of the provisos in section 37(7)(a)(i) and (ii)), to convert themselves from shareholders to 'redemption creditors' after the commencement of a winding up. Acknowledging the very limited practical application of the section, which must arise given the construction favoured by the Privy Council, the Board noted that 'the likelihood in practice of successful section 37(7) claimants may well be slight'.

Importantly, however, the Privy Council reaffirmed the CICA's finding that the claims of unpaid redeemers rank behind the claims of ordinary third party creditors;[9] although, it left open the seemingly difficult question as to the priority to be afforded between claims for unpaid redemption proceeds that sit outside section 37(7) and those notional claims arising under the section.

Unfortunate consequences

Essentially, in the context of the articles of most contemporary Cayman Islands investment funds, this decision means that redeeming shareholders have valid claims for the payment of redemption proceeds as at the relevant 'redemption day', which claims are enforceable in a winding up regardless of (i) whether those claims are based on a NAV which has been wholly mis-stated (as was the case with respect to Herald); and (ii) a company's ability to make payment out of either share capital or share premium at any time prior to the commencement of a winding up.

The Privy Council also went a step further than it did in *Fairfield Sentry v Migani*[10] where, in the context of an action by the liquidators of Fairfield Sentry seeking to recover redemption proceeds which had already been paid to investors based on a mis-stated NAV, the Privy Council found those proceeds could not be clawed back in circumstances where payment had already been made prior to the commencement of the winding up. In this case, the Privy Council sought to draw 'a precise line' (or rather extend the line) so as to allow investors to escape loss in a liquidation where they have ceased to be a shareholder under the terms of the relevant articles of association prior to the commencement of the winding up, notwithstanding that no payment had in fact been made (nor could it have been made as a matter of fact at the relevant time).

It is an unfortunate consequence that unredeemed investors will ultimately bear the loss in a liquidation once claims which are based on a mis-stated NAV have been paid, simply because certain investors submitted redemption requests a matter of days before others and in circumstances where the resultant suspension was due to no fault of the company or its directors, but solely based on the exposure of the Madoff fraud (which was of course a common misfortune visited upon all investors, redeemed or otherwise).

Conclusion

Whilst the Privy Council's decision provides finality as to the appropriate treatment in the Cayman Islands of claims for the payment of redemption proceeds in a winding up, it is likely that new and existing funds alike (together with their respective investors and prospective investors) may reconsider new formulations of what 'redemption' means under their individual

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7 The Later Redeemers did not assert positive claims, but rather supported the position taken by the Additional Liquidator that Primeo (and its representative class) and the Late Redeemers claims were rendered unenforceable by reason of the operation of section 37(7) of the Companies Law.

8 See *In re Humber Ironworks and Shipbuilding Co.* (1868-69) L.R. 4 Ch. App. 643, 646-647 per Selwyn LJ.

9 Reversing the effect of the Grand Court's ruling that those claims ranked pari passu – an argument which was pursued forcefully by Primeo in the CICA, but ultimately abandoned altogether in its case in the Privy Council.

10 [2014] UKPC 9.

constituent documents in order to navigate the unfortunate loss-allocation consequences which may arise as a result of this judgment. The door of course remains open for legislative reform in light of what has now been shown to be a very limited (potentially even non-existent) practical application of section 37(7) of the Companies Law.

Matthew Goucke and Chris Keefe act for the Additional Liquidator of Herald.[11]

Notes

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

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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