Conyers Dill & Pearman

Privy Council Clarifies the Old Law (1989-2011 position) Regarding Section 37 Redemptions

Authors:
Paul Smith, Partner, Head of Cayman Islands Litigation & Restructuring
Ben Hobden, Partner

In late 2008, *RMF Market Neutral Strategies (Master) Limited* ("RMF") sought to cash in its investments in *DD Growth Premium 2X Fund* (In Official Liquidation) (the "Company"), a feeder fund incorporated in the Cayman Islands, by exercising its right to have its shares in the Company redeemed. In response, the Company paid US$23 million to RMF (less than 40% owed to RMF by way of redemption) before running out of money and being wound up.

When the Company was wound up it transpired that it had, in effect, become a Ponzi scheme and that the Company was insolvent at the date of the payments. There was no suggestion that any of the redeeming investors, including RMF, knew about the fraud.

The liquidator of the Company sought to claw back the payments made to RMF. Various grounds were relied upon that: the payments were illegal returns of capital; there was an automatic restitutionary right to recover the illegal payments; the payments were fraudulent preferences; and there was a constructive trust/knowing receipt claim.

The clawback claim failed in the Grand Court at first instance and in the Court of Appeal. The Privy Council, in a split 3/2 decision, held that the redemption payments were an illegal return of capital which failed the solvency test. The Privy Council unanimously held that the liquidator had no automatic restitutionary right to the return of the payments and that the knowing receipt claim must be remitted to the Grand Court to find the relevant facts. The rejection by the Grand Court of the fraudulent preference claim was not appealed. The result was that the liquidator did not make the recovery sought and a further trial has to take place.

It is to be noted that as is usual with Cayman Island funds, the nominal or par value of the shares in question was *de minimis*, being US$0.001 per share. The NAV was substantially higher.

Illegality

The illegality issue turned on the construction of Section 37 of the *Cayman Islands Companies Law* (the "Companies Law") as it existed between 2007 and 2011. This deals with the manner in which redeemable shares issued by a company are to be redeemed.

The law, in its pre-2011 form, was difficult and uncertain (as shown by the 3/2 split in the Privy Council), suffering to a substantial extent from the piecemeal way in which the provisions of the Companies Law have been enacted and reformed over time. The question of law to be determined was essentially whether a payment out of a company's share premium account towards the premium payable on redemption of the shares (rather than towards the nominal amount of those shares) was to be treated as a deemed capital payment and subject to the solvency test in Section 37(6) of the Companies Law.

The Board of the Privy Council, overturning the rulings of the Grand Court and Court of Appeal, found by a 3/2 majority that the US$23 million in payments paid to RMF were unlawful because they were deemed capital payments, and that the solvency test in Section 37(6) was triggered. The Company was insolvent at the time the payments were made and so the payments were unlawful. In a very well-articulated judgment, Lord Hodge on behalf of the minority in the Privy Council disagreed.

Restitution

The Board's ruling on illegality necessarily led to consideration of the issue of restitution, namely whether payment of the redemption proceeds is recoverable by the Company, either at common law on the ground of unjust enrichment/ money had and received or in equity on the ground that the redeeming shareholder is accountable as a constructive trustee on the footing of knowing receipt.

In agreement with submissions made on behalf of RMF, the Board concluded that the Company was not entitled to recover the payments to RMF at common law on the ground of unjust enrichment/money had and received. A common law liability in restitution depends on the defendant having been unjustly enriched by the receipt. This may possibly be the situation where money was paid for an illegal purpose. In this instance, however, the redemption proceeds were paid because the shares had been properly redeemed and cancelled on the redemption date, and that thereafter a valid debt was owed by the Company to RMF. The illegal payment discharged a valid and lawful debt owed to RMF. An enrichment will not be unjust if the payment was made by the claimant under a valid contractual, statutory or other legal obligation. Accordingly the common law claim in unjust enrichment/money had and received failed.

Although the payments were made to RMF for valid consideration, they were illegal by statute and had accordingly been authorised by the Company's directors in breach of their fiduciary duties to the Company. In such circumstances, the equitable rules of knowing receipt come into play. A redeeming investor cannot retain assets which he knows to have been paid to him in breach of the fiduciary duties of the directors.

There were no findings of fact in the Grand Court on which the liquidator could found a claim of knowing receipt (it had been unnecessary for the Grand Court to determine the knowing receipt at the original trial). The knowing receipt claim has therefore been remitted to the Grand Court to determine whether RMF is accountable for those payments as a constructive trustee. Notwithstanding this, the Board of the Privy Council remarked that the required knowledge on the part of the defendant, especially in relation to apparently routine transactions who lawfulness depends on the internal affairs of the company, may be hard to prove.

In summary, the clarification provided by the Privy Council about the legality of the redemption payments is largely a matter of historical interest. The current, post 2011 law, is in fact in line with the decision of the minority in the Privy Council and Court of Appeal. Had the redemption payments been made after 2011 they would have been legal. Redeeming investors can now be paid share premium on redemption of their shares without the imposition of a solvency test. The Privy Council has established that there is no automatic clawback of illegal redemption payments. The issue of constructive trust remains a live one however, and the case will no doubt remain of interest to investors and liquidators alike.

Paul Smith and Ben Hobden of Conyers acted for RMF in the appeals.

AUTHORS:

PAUL SMITH
PARTNER, HEAD OF CAYMAN ISLANDS LITIGATION & RESTRUCTURING
paul.smith@conyersdill.com
+1 345 814 7777

BEN HOBDEN
PARTNER
ben.hobden@conyersdill.com
+1 345 814 7366

GLOBAL CONTACTS:

FAWAZ ELMALKI
DIRECTOR
HEAD OF DUBAI OFFICE
fawaz.elmalki@conyersdill.com
+9714 428 2900

NIGEL K. MEESON QC
PARTNER
HEAD OF ASIA DISPUTES & RESTRUCTURING GROUP
nigel.meeson@conyersdill.com
+852 2842 9553

LINDA MARTIN
DIRECTOR
HEAD OF LONDON OFFICE
linda.martin@conyersdill.com
+44(0)20 7562 0353

ALAN DICKSON
DIRECTOR
HEAD OF SINGAPORE OFFICE
alan.dickson@conyersdill.com
+65 6603 0712

ABOUT CONYERS DILL & PEARMAN

Conyers Dill & Pearman is a leading international law firm advising on the laws of Bermuda, the British Virgin Islands, the Cayman Islands and Mauritius. Conyers has over 130 lawyers in eight offices worldwide and is affiliated with the Conyers Client Services group of companies which provide corporate administration, secretarial, trust and management services.

For further information please contact: media@conyersdill.com