

## Article

## Certainty for Investors: Privy Council Rules on the Distribution Methodology for Investment Funds in Liquidation

Authors: Ben Hobden, Partner | Sarah McLennan, Associate

The Privy Council has ruled that Cayman Islands law does not permit a liquidator of a Cayman Islands based open-ended investment company in solvent liquidation to rectify the company's register so as to alter the members' legal rights. In *Pearson v. Primeo Fund (In Official Liquidation)* [2020] 1 WLUK 187, the Privy Council rejected a proposal by a liquidator, seeking to achieve what they considered to be a fairer distribution to members who were victims of fraud, to use a net investment methodology. The Privy Council held that absent internal fraud, distributions to investors should be based on shareholdings as at the commencement of the liquidation.

### Background

Herald Fund SPC (Herald) was founded as a feeder fund for the investment vehicle, Bernard L Madoff Investment Securities (BLMIS), which was later found to be a fraudulent Ponzi scheme orchestrated by the infamous Bernard Madoff. Madoff solicited investments on the basis that he was operating an actively managed portfolio but never made any actual investments. Instead he accumulated them and used them to pay off departing investors whilst at the same time publishing entirely fictitious reports of a seemingly constantly profitable portfolio. BLMIS crashed in 2008 shortly after the Lehman failure, basically having run out of cash, thereby preventing the scheme from continuing.

Herald invested all of its assets into BLMIS and therefore suffered significant loss as a consequence of the Madoff fraud. Primeo Fund (Primeo), another Cayman Islands fund, was a substantial investor in Herald and entered liquidation itself.

Upon discovering the Madoff fraud, Herald suspended the publication of its Net Asset Value (NAV) and the issue and redemption of its shares. Some of its investors had redeemed their investments in part already before the scheme collapsed (like Primeo) but remained members in respect of the balance. Other investors had not redeemed any part of their investments. They were greater victims of the fraud because investors, such as Primeo, had received a return of capital and also the fictitious profits represented by the NAVs, now known to be incorrect as a result of the Madoff fraud.

After the BLMIS scheme collapsed, recoveries made by the BLMIS liquidators meant that Herald stood to receive a substantial sum on account of its investment. Unable to recover amounts owing to it, Primeo petitioned to wind up Herald which was placed into liquidation in July 2013.

Herald's (additional) liquidator, Mr. Pearson, was directed by the court to carry out the following functions:

"Settling the list of contributories pursuant to section 122(1) of the Companies Law and determining related issues, including whether [Herald]'s register of members should be restated pursuant to section 112(2) of the Companies Law and whether [Primeo's] shareholding in [Herald] should be adjusted on the ground that the consideration for the issue of its shares was the transfer to [Herald] of the portfolio of securities and/or cash held by Primeo in its account with BLMIS, the amount or value of which had been fraudulently overstated."

## Liquidator's proposed distribution methodology

The liquidator proposed that the power under section 112(2) of the Companies Law (2018 Revision) allowed them to make a distribution to members in such a way to achieve a fairer result than would be achieved by distributing in accordance with the shareholdings recorded in the register of members.

Section 112(2) 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 from time to time, the liquidator shall have power to settle and, if necessary rectify the company's register of members, thereby adjusting the rights of members amongst themselves.”*

The liquidator proposed to identify each member's net investment in the company, the amount they had paid less any amount received in redemption; calculate each member's net investment as a percentage of the total net amount invested by the company; and restate the register in accordance with those percentages. This was in an effort to even out the impact of the Madoff fraud on investors who remained members at the commencement of the liquidation. If permitted, it would have resulted in members receiving significantly different returns than if distributions were made *pari passu* and in accordance with the shareholdings recorded in the register of members at the date of the commencement of the liquidation.

Under Order 12, rule 2 of the Companies Winding-Up Rules 2018, a liquidator of a solvent fund must exercise their power to rectify the company's register of members where the NAV is “not binding upon the company and its members by reason of fraud or default”. Furthermore, where it is impractical or not cost effective to rectify the company's register of members in accordance with the true NAV, liquidators are required to “rectify the register in such a manner which is both cost effective and fair and equitable between shareholders”.

The liquidator's position was that the statutory framework provided a broad power allowing a departure from the members' legal rights as set out in the constitutional documents of the company where there had been an external fraud on the solvent fund. The liquidator was successful at first instance but lost in the Court of Appeal of the Cayman Islands.

The liquidator appealed the Court of Appeal of the Cayman Island's determination that section 112(2) of the Companies Law (2018 Revision) 2018 (Cayman Islands) did not empower them to rectify the company's register so as to alter the members' legal rights. The respondent to the appeal application was Herald's principal investor, Primeo, representing the class of investors whose interests would be best served by adherence to their contractual rights as reflected by the register of members.

## Decision

The Privy Council dismissed the appeal. Although the Board appeared sympathetic to the arguments raised by the liquidator, the question was not whether the liquidator's proposal would achieve a more just result between Herald's members, as victims of Madoff's fraud, than a distribution in accordance with their contractual rights as at the commencement of the liquidation. The real matter that required determination was whether section 112(2) of the Cayman Companies Law permits any departure from members' contractual rights at the commencement of the liquidation, as the basis for the distribution among the members of the surplus.

The Privy Council held that phrase “settle ... the register of members” was adapted from the immediately preceding phrase “settle a list of contributories” in section 112(1). That subsection contemplates the creation of a document which would identify what contributories were liable to contribute to the assets of an insolvent company, or, in a solvent liquidation, the amounts to be taken into account as a debit or set-off against what they would otherwise be entitled to receive from the surplus as members. The power under section 112(2) to settle and, if necessary, rectify the register of members was designed to enable the liquidator to ensure that the register was a reliable basis for distributing any surplus because it fully and accurately reflected the members' legal rights. The register might be incomplete, so that it needed to be settled in the sense of being completed; or it could be complete but plainly wrong, so that it needed to be rectified. That would be to use the concept of rectification in an ordinary sense of correcting an error in a document so as to bring it into line with the underlying legal rights of the affected parties. That interpretation was not undermined by the subsequent reference to adjusting the rights of the members among themselves. That was a well-known concept in liquidation in which “adjustment” did not involve a departure from the legal rights of the persons concerned.

These conclusions were supported by further considerations:

- The terms of subordinate legislation introduced to regulate the use of section 112(2). Order 12, rule 2 of the Companies Winding Up Rules 2018 concerns rectification of the register when, due to an internal fraud, the published NAVs of a solvent open-ended investment company are not binding and the register is not a reliable basis for distributing the surplus (the fraud in this case being external not internal).

- The construction put forward by the liquidator would create a large and unprecedented change in the law by empowering liquidators to impose a distribution scheme of their own devising in substitution for members' legal rights, without providing liquidators with guidance as to when that would be appropriate or the contents of a scheme.
- Any such power would run counter to the fundamental liquidation principle that company assets were to be applied *pari passu* among stakeholders according to their legal rights at the commencement of the liquidation.
- Furthermore, section 112(2) had not been introduced with the mischief of a Ponzi scheme which did not unravel the NAVs of a feeder fund like Herald in mind.

Lady Arden delivered a separate opinion. She agreed that the liquidator's proposal should be dismissed. However, she considered that elements of the liquidator's proposal could be achievable. Although rectification was not permitted save for substantial compliance with members' legal rights, it was not confined to contractual rights. Section 112 also conferred power on the liquidator to adjust the rights of the contributories and take into account of any obligation the member had to the company. That included an obligation to repay any proceeds of redemption of shares if the member was not entitled to retain those proceeds for any reason. The liquidator would then be able to deduct redemption proceeds in accordance with his proposal.

## Comment

Absent internal fraud, a fund's NAV that has been calculated in accordance with the company's constitution remains legally binding. This is the case even where the NAV reached did not reflect the fund's underlying assets because of an external fraud committed against the fund. What happened here was not an internal fraud but an external one, committed by BLMIS on Herald.

If there is an internal fraud, the NAV will not be binding even if calculated in accordance with the articles. The liquidator will then, as confirmed by the Privy Council, either have to carry out what could be a painstaking process of reconstructing the NAVs in order to determine what those rights are, or, if that is impracticable, have to apply a fair and equitable proxy for those rights and rectify the register or members in either case.

From an investor's point of view the Privy Council's decision provides certainty which will be welcomed. The Cayman courts have long endorsed and upheld members' bargained for contractual rights which is one of the many reasons why the Cayman Islands remains a premier jurisdiction for investment funds.

---

## Authors:

### Ben Hobden

#### Partner

ben.hobden@conyers.com

+1 345 814 7366

### Sarah McLennan

#### Associate

sara.mclennan@conyers.com

+1 345 814 7882

This article is not intended to be a substitute for legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and give general information.

For further information please contact: [media@conyers.com](mailto:media@conyers.com)