Privy Council confirms narrow scope of Liquidator's rectification power in the Cayman Islands

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The Board of the Privy Council (**Board**) recently handed down its judgment in *Pearson v Primeo*,[1] the latest Cayman Islands decision to emanate from the Bernard Madoff Ponzi scheme. The Board held that, when distributing surplus assets in a solvent liquidation of a Cayman Islands investment fund, the liquidator's power to rectify the register of shareholders pursuant to section 112(2) of the Companies Law (**Law**) is limited to giving effect to shareholders' underlying legal rights, as they were at the commencement of the liquidation. The Board found that section 112(2) does not permit rectification of the register of shareholders which would override the existing legal rights of shareholders.

Background

Herald Fund SPC (in official liquidation) (**Herald**) was one of the largest feeder funds invested in Bernard L Madoff Investment Securities LLC (**BLMIS**), the main vehicle of Bernard Madoff's massive Ponzi scheme.

Herald struck net asset valuations (**NAVs**) pursuant to its articles of association which were binding as between Herald and its shareholders, including for the purposes of subscription and redemption. These binding NAVs were used to determine how many shares should be purchased from or allotted to Herald's shareholders, and reflected in Herald's register of shareholders.

A shareholder's rights to distributions in Cayman Islands liquidations are based on their shareholding as reflected in the register of shareholders at the commencement of the liquidation. However, Herald's additional liquidator (**Additional Liquidator**) proposed a different method of distribution, the Net Investment Method, which he considered would produce a fairer outcome when distributing Herald's surplus assets.

The Net Investment Method is a concept imported from United States law and applied in that jurisdiction where the liquidating entity was implicated in the fraud. Pursuant to the Net Investment Method, a shareholder's entitlement is calculated on a "cash in cash out" basis. That is, by deducting the amount of money a shareholder redeemed from the amount of money invested to determine their net investment or 'net equity' position. The application of the Net Investment Method would require the Additional Liquidator to rectify the register of shareholders and he argued that he had the power to do this pursuant to section 112(2) of the Law.

Primeo contended that section 112(2) did not create a free-standing power for a liquidator to rectify the register and disregard shareholders' existing legal rights as at the commencement of the liquidation. Rather, section 112(2) only permitted a liquidator to give effect to those existing rights.

The Board's decision

Upholding the decision of the Cayman Islands Court of Appeal (**CICA**), the Board rejected the Additional Liquidator's argument that section 112(2) conferred a broader discretionary power on a liquidator to disregard shareholders' legal rights and adopt a method of distribution which, in a liquidator's view, produced a more equitable outcome.

Applying a contextual interpretation of section 112(2), which included a review of earlier iterations of the Law, similar provisions in other commonwealth jurisdictions, and the statutory regime as a whole (including the Cayman Islands Companies Winding Up Rules), the Board considered that the phrase "*adjusting the rights of members amongst themselves*" did not encompass an adjustment of legal rights, but rather an adjustment required to correct an error or omission in the register of shareholders.

The Board considered that to permit an adjustment of shareholders' legal rights in the manner proposed by the Additional Liquidator would be inconsistent with the fundamental principle applicable to liquidations in the Cayman Islands (and most common law jurisdictions) that the assets of the company are to be applied *pari passu* among the classes of stakeholders in accordance with their legal rights as at the commencement of the liquidation.

Following the Board's decision in *Fairfield Sentry*,[2] the Board held that Herald's shareholders were contractually entitled to insist upon Herald's valuation of their investment and the number of shares allotted to them as reflected in the register of shareholders. Where Herald itself was not a fraud, but had inadvertently invested in a fraud, there was no basis for vitiating the shareholders' legal rights.

Lady Arden also dismissed the Additional Liquidator's appeal, but delivered a separate judgment. She held that section 112(2) had a wider scope and permits a liquidator to adjust a shareholder's rights to ensure that they are not entitled to any distributions until paying all debts due to the company. Lady Arden used the example of payments made to shareholders out of the share premium account which were subsequently deemed to be unlawful pursuant to section 34 of the Law (i.e. because the value of the share premium account had been inflated by fraud) and which may need to be repaid.

Discussion

The Board's decision confirms that section 112(2) does not give a liquidator the power to rectify the register of shareholders in a way which alters the underlying legal rights of shareholders. This decision should give comfort to investors and stakeholders of Cayman Islands investment funds that their contractual rights will be preserved following the liquidation of the fund. The Board's decision ensures that investors are not exposed to the uncertainty of losing their pre-existing contractual rights in exchange for an alternative distribution regime not prescribed or defined at law but deemed fairer by a liquidator in the circumstances of any given liquidation.

[1] *Pearson (in his capacity as Additional Liquidator of Herald Fund SPC (in Official Liquidation) (Appellant) v Primeo Fund (in Official Liquidation) (Respondent) (Cayman Islands)* [2020] UKPC 3

[2] *Fairfield Sentry Limited (in Liquidation) (Appellant) v Migani and others* [2014] UKPC 9

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