

UPDATE

Privy Council confirms redeemed investors are creditors – Q&A

In a long-awaited landmark decision the Judicial Committee of the Privy Council has upheld the decisions of the Grand Court and Court of Appeal of the Cayman Islands and confirmed that redeemed but unpaid fund investors are to be treated as creditors in a liquidation, with claims which rank ahead of the claims of unredeemed investors. Read about this decision in Q&A format including the broader ramifications of this decision.

What was the background to the transaction?

Primeo is a Cayman hedge fund and indirectly invested all of its assets into Bernard L Madoff Investment Securities LLC (**BLMIS**) through another Cayman fund, Herald.

Primeo, like a number of other Herald investors (the **December Redeemers**), submitted valid requests to Herald for the redemption of their shares (the **Shares**). Under Herald's articles of association, the Shares were to be redeemed on 1 December 2008. Upon redemption, Herald's Articles also provided that all of the December Redeemers' rights as investors in Herald were terminated, except the right to receive the monies owed as a result of the redemption (the Redemption Monies).

On 1 December 2008, the Shares were redeemed. However, before the Redemption Monies could be paid, it was discovered that BLMIS was a massive Ponzi scheme on 11 December 2008. The next day, Herald's directors suspended the determination of Herald's net asset value and, subsequently, the payment of the Redemption Monies (the **Suspension**).

Primeo subsequently applied for voluntary liquidation. Despite the fact that Herald was 100% invested into BLMIS, it refused to be placed into liquidation, and Primeo was forced to bring a winding up petition. It was contested by Herald, but the Court ultimately ordered that Herald be placed into liquidation.

The question which Herald's additional liquidator (who was appointed for the sole purpose of resolving issues regarding the status of stakeholders) (the **Additional Liquidator**) had to decide is whether Primeo and the other December Redeemers were entitled to be treated as creditors of Herald in the amount of the Redemption Monies or whether they should be treated as investors.

How did the case reach the Privy Council?

Primeo's status as a creditor or investor turned on the construction of section 37(7)(a) of the Cayman Companies Law (**Section 37(7)**).

Section 37(7) provides that, where a company is being wound up and, at the commencement of that winding up, any of its shares which are, or are liable, to be redeemed have not been redeemed, the redemption may only be enforced against the company in the liquidation if certain narrow conditions are met.

The parties agreed that Section 37(7) applied only to shares which had not been redeemed and, if Section 37(7) did not apply in relation to the Shares, Primeo and the other December Redeemers should be treated as creditors without having to meet those conditions. However, there was a dispute as to what the term 'redemption' meant in this context.

Primeo's position was that redemption meant redemption pursuant to Herald's Articles. Because it was agreed that the Shares had been redeemed under Herald's Articles, Primeo considered that Section 37(7) did not apply and it was properly regarded as a creditor.

The Additional Liquidator argued that redemption did not mean redemption under Herald's Articles but instead was defined as a process which only ended upon the actual payment of the Redemption Monies. Accordingly, as Primeo and the December Redeemers had not been paid the Redemption Monies, Section 37(7) applied and they should be treated as investors.

Both the Grand Court (Cayman's first instance court) and the Cayman Islands Court of Appeal (in a unanimous decision) agreed with Primeo's interpretation holding that, for the purposes of Section 37(7), redemption took place once the Shares had been redeemed under Herald's Articles. As it was uncontroversial that the Shares were redeemed on 1 December 2008, both Courts held that Primeo and the December Redeemers fell outside Section 37(7) and were to be treated as creditors.

The Additional Liquidator appealed the CICA's decision to the Privy Council.

What did the Privy Council decide?

The Privy Council unanimously agreed with Primeo's interpretation confirming the decisions of both lower courts. It decided that the term 'redemption' in Section 37(7) did not mean a process culminating in the payment of the redemption proceeds. The Privy Council found that redemption under section 37(7) could not have a different, autonomous meaning from redemption as defined by a company's articles and, once that had taken place, the Shares were outside the scope of Section 37(7). As such, Primeo and the December Redeemers had provable creditor claims in Herald's liquidation for the unpaid Redemption Monies.

Are there any other important aspects of the Privy Council's decision?

Yes. There were a number of additional points which the Privy Council decided which had not previously been decided by the Cayman Courts in any other proceedings.

First, the Privy Council confirmed the ranking of Primeo's and the December Redeemers' creditor claims in Herald's liquidation. It determined that creditor claims for unpaid redemption proceeds should rank ahead of the claims of investors to a return of capital. This is a common sense result given that, in the normal course, creditor claims have priority over an investor's right to a return of equity. The Privy Council also decided that those creditor claims would also rank behind the claims of creditors which were not dependent upon their status as former investors (such as trade creditors).

Second, the Privy Council also gave some guidance on the operation of Section 37(7) for those investors who fell within its scope. It considered that Section 37(7) applied in circumstances *in which redemption...ought to have been, but was not effected, by the company before the commencement of the winding up*. In other words, subject to the satisfaction of the certain conditions, it gave a redeeming investor an ability to enforce a redemption thereby protecting it from a company's failure to process the redemption.

What are the broader ramifications of this decision?

The decision of the Privy Council demonstrates that the Cayman Courts will honour the contracts (in the form of a company's constitutional documents) even when a company enters into liquidation. Indeed, in coming to its decision, the Privy Council placed great emphasis on the ability of a fund and its investors to shape their relationship, including the point at which investor's rights come to an end.

The latter point is particularly important for the sophisticated market participants in the funds industry. Had the argument being advanced by Herald succeeded, it would have caused considerable confusion because 'redemption' would have had different meanings in different contexts and the ability of investors to make decisions based upon the clear, ordinary meaning of the agreements they entered into would have been eroded.

Peter Hayden, Rocco Cecere and Christopher Levers of Mourant Ozannes and Tom Smith QC of South Square acted on behalf of Primeo throughout these proceedings.

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