

UPDATE

# Privy Council confirms redeemed investors are creditors

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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.

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This decision will be of significant interest to the fund industry as it confirms the prevailing market view on this issue and ensures that the contractual bargain enshrined in the subscription documentation between the fund and investors is respected.

## Background

The decision arises from the ongoing representative proceedings between Primeo Fund (in official liquidation) (**Primeo**) and Herald Fund SPC (in official liquidation) (**Herald**), both victims of the infamous fraud perpetrated by Bernard Madoff (**Madoff**).

Primeo was an indirect investor in Bernard L Madoff Investment Securities LLC (**BLMIS**) via its investment in Herald, a BLMIS Feeder Fund. Primeo and a number of other Herald investors (the **December Redeemers**) submitted redemption requests for a redemption date of 1 December 2008. It was common ground between Primeo and Herald that the shares of Primeo and the other December Redeemers, which were the subject of the redemption requests (the **Shares**), had been redeemed, pursuant to Herald's articles of association, on 1 December 2008.

However, on 11 December 2008, before the December Redeemers were paid the redemption proceeds, Madoff confessed that BLMIS was a fraud and Herald suspended the determination of net asset value on 12 December 2008 and, subsequently, the payment of redemption proceeds (the **Suspension**).

On 16 July 2013, upon a petition presented by Primeo, an order was made placing Herald into official liquidation.

## Section 37(7) of the Law

As discussed in our previous briefing notes dated [24 June 2015](#) and [29 July 2016](#) this aspect of the representative proceedings concerned the application of section 37(7) of the Companies Law (2007 Revision) (the **Law**) upon the Shares.

Section 37(7) of the Law provides, *inter alia*, that the redemption of shares which 'are to be redeemed' or 'are liable to be redeemed' but have not been redeemed before the commencement of the liquidation, may only be enforced if (a) the terms of the redemption provided for it to take place at a date earlier than

the commencement of the winding up (**Proviso 1**) and (b) the company could have lawfully distributed the redemption proceeds prior to the commencement of its liquidation (**Proviso 2**) (together, the **Provisos**).

The key issue in the proceedings at both first instance and in the Court of Appeal was whether the Shares fell within the ambit of section 37(7), such that the Shares could only be redeemed if the Provisos were met or whether, as contended for by Primeo, section 37(7) did not apply to the Shares such that Primeo was simply entitled to prove as a creditor for its unpaid redemption proceeds.

At first instance, the Grand Court, agreeing with Primeo, held that section 37(7) did not apply to the Shares. It found that section 37(7) only applied to shares which had not been redeemed pursuant to a company's articles of association and, as the Shares had been redeemed pursuant to Herald's articles, they fell outside the ambit of section 37(7).

On appeal, the Cayman Islands Court of Appeal (the **CICA**) upheld the Grand Court's ruling. It unanimously agreed that section 37(7) does not apply where, at the commencement of the winding up, the shares in question have been redeemed in accordance with the company's articles of association. In those circumstances, a redeemed investor's claim for unpaid redemption proceeds was a provable claim falling within section 139(1) of the Law.

The CICA also determined an additional point, not decided below, that a claim for unpaid redemption proceeds falls within section 49(g) of the Law, such that those claims are paid in priority to the claims of unredeemed investors but rank behind the claims of ordinary, unsecured creditors.

### **The Privy Council Judgment**

Herald appealed the CICA's decision. In addition, two further representative parties obtained leave to intervene in the appeal to ensure that their class interests were represented: (a) the **Late Redeemers** (investors who submitted redemption requests in December 2008 prior to the Suspension) and (b) the **Later Redeemers** (investors who submitted redemption requests after the Suspension).

After hearing argument from each of the four parties, the Privy Council unanimously dismissed Herald's appeal. It held that the Shares fell outside the scope of section 37(7) such that Primeo and the December Redeemers are entitled to prove under section 139(1) of the Law for their unpaid redemption proceeds.

The Privy Council found that, contrary to the argument advanced by Herald, the term 'redemption' in section 37(7) did not mean a process culminating in the payment of the redemption proceeds. It agreed with Primeo that payment is *clearly not an inherent element of the redemption...by the company of its own shares*. Instead, *the essence of redemption is...the surrender of the status of shareholder, with all attendant rights*. 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.

In this connection, the Privy Council recognised the freedom of the fund and its investors to *shape their relationship*, including determining the point at which investors' rights are extinguished.

Section 37(7), consistent with its English statutory predecessors, was intended to apply in circumstances *in which redemption...ought to have been, but was not effected, by the company before the commencement of the winding up*. It does not, as suggested by Herald, serve to convert a redeemed investor from a creditor back to an investor. Rather, subject to the satisfaction of the Provisos, a redeeming investor is entitled to enforce a redemption to ensure that it is not prejudiced by the company's failure to process the redemption.

A further aspect of the Privy Council's decision which is important is the clarification of the liquidation 'waterfall'. It confirmed the ruling of the CICA that section 49(g) applied to redemption creditor claims and, as a result, the claims of Primeo and the December Redeemers are subordinated to those of ordinary unsecured creditors but rank ahead of the equity claims of investors.

The Privy Council noted, in *obiter*, that pursuant to the waterfall set out in section 37(7)(b), December Redeemers would either take in priority to, or *pari passu* with, investors with claims falling within section 37(7).

## Proviso 1

The Privy Council also had to grapple with the position of the Late and Later Redeemers. The Late Redeemers accepted that they fell within the scope of section 37(7) and, as a result, to enforce their redemption claims, they needed to satisfy both Provisos. The Late Redeemers contended that, although the Suspension had the effect of suspending the determination of net asset values for future redemption dates, this did not mean that redemption could not occur on those dates. The Privy Council disagreed. It found that the Suspension suspended not only the determination of net asset value for future redemption dates but also redemption on those dates, given the close link between valuation and redemption. As the Suspension was not lifted prior to the commencement of Herald's liquidation, the Late Redeemers' claims were defeated by Proviso 1.

By this reasoning, the Later Redeemers' redemption requests were also defeated by Proviso 1. However, in deciding this issue, the Privy Council also cast doubt regarding the validity of the Later Redeemers' redemption requests, questioning whether a redemption request, lodged after the Suspension, could be effective.

## Conclusion

The decision of the Privy Council brings welcome finality to this issue. It demonstrates that the Court will take a consistent approach to the meaning of terms, that the drafters of a fund's constitutional documents properly understood the law, and that the Courts will respect freedom of contract. 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 freedom of contract would have been curtailed, which would have been very damaging for the fund industry in the Cayman Islands. The fund industry should take comfort from the fact that Herald's arguments were comprehensively rejected at every level of the Court system.

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.

## Contacts

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