UPDATE

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Admissibility and priority of shareholder misrepresentation claims in a Cayman Islands liquidation

Update prepared by Simon Dickson and Laura Stone (Cayman Islands)

Following the recent conflicting decisions in *HQP Corporation (in official liquidation)*[1] (***HQP***) and *Direct Lending Income Feeder Fund, Ltd (in official liquidation)*[2] (***DLI***), Simon Dickson and Laura Stone of Mourant Ozannes (Cayman) LLP consider whether shareholder misrepresentation claims can be admitted in a Cayman Islands liquidation. They also review the unresolved question of how such claims rank in the order of priorities.

Introduction

The decisions in *HQP* and *DLI* were heard by the Cayman Islands Grand Court only one week apart. The decisions considered the long-standing principle established by the House of Lords in *Houldsworth v City of Glasgow Bank*.[3] The House of Lords held that a person induced by fraud to subscribe for shares may not bring an action for damages against the company whilst a shareholder. A shareholder cannot both retain its shares and sue the company for damages. The only remedy available is recission of the contract. Given recission is impossible when the company is being wound up, a shareholder is barred from bringing such claims in a liquidation (the **Rule in *Houldsworth***).

The Rule in *Houldsworth* was handed down in 1880, the same year that Edison patented the light bulb and when company law was in its infancy. It has been reversed by statue in a number of common law jurisdictions, but not in the Cayman Islands. This has left open the question as to whether the Rule in *Houldsworth* applies and, if not, how such claims would rank in a liquidation.[4]

Background

HQP Corporation (HQP)

HQP was a Cayman Islands exempted company and part of a group of companies in mainland China which traded automobile parts online. HQP raised capital through private equity funding and preferred shares were issued to investors following each round of funding. Various allegations were made against the company, including that the scheme of promotion was conducted on a fraudulent basis. The company was subsequently put into liquidation on 5 April 2022.

Direct Lending Income Feeder Fund, Ltd. (DLIFF)

DLIFF was an offshore feeder fund for DLI Capital, Inc. On 22 March 2019, the SEC charged the investment manager with a multi-year fraud, alleging that DLI Capital deliberately overstated the value of loans.

[1] *In the matter of HQP Corporation Limited (in official liquidation)* (unreported, 7 July 2023, Doyle J) (***HQP***).

[2] *In the matter of Direct Lending Income Feeder Fund, Ltd (in official liquidation)* (unreported, 13 March 2024, Segal J).

[3] (1880) 5 App Cas 317.

[4] *Houldsworth* was reversed or substantially modified by section 111A of the UK Companies Act 1985, introduced by section 131 of the UK Companies Act 1989. That statutory provision is now contained in section 655 of the UK Companies Act 2006.

Subsequently, DLIFF (together with the rest of the DLI Group) was placed in receivership in the United States, and on 25 July 2019, put into liquidation.

Given the allegations of fraud, the question arose in both liquidations as to whether investors could bring claims for misrepresentation against the company in respect of their share subscriptions (**Misrepresentation Claims**). To resolve this issue, the Court in both cases had to decide:

- whether Misrepresentation Claims by shareholders are provable in a liquidation (the ***Houldsworth* Issue**); and
- if Misrepresentation Claims are provable, where such claims would rank in the order of priorities (the **Priority Issue**).
- In addition, in DLI the company had a number of redemption claims, where shareholders had redeemed their shares and were accordingly owed a debt by the company (Redemption Claims). Therefore, the Court had to consider where a Redemption Claim should rank against any Misrepresentation Claim (the **Redemption Issue**).

The decisions

The *Houldsworth* Issue

In *HQP*, the Court analysed the effect of English precedent on Cayman Islands law and found a number of avenues which allowed it to depart from a decision of the House of Lords. Given this, the Court concluded that the Rule in *Houldsworth* did not apply on the basis that firstly, its reasoning was inconsistent with modern day company law, and secondly, that the rule was obsolete, having been abolished by statute in England in 1989.

The Court in *DLI* disagreed and found the Rule in *Houldsworth* did apply and that there was a bar to Misrepresentation Claims. The rule was not obsolete in that it enshrined important principles of capital maintenance. The underlying rationale for the rule was the need to preserve a company's capital on a winding up to pay the company's creditors. Allowing damages claims for misrepresentation by shareholders and the concomitant reduction of capital would be inconsistent with that rationale. Accordingly, the Rule in *Houldsworth* remained relevant and consistent with modern day company law.

The Court went on to consider whether this meant there was an absolute bar to such claims but could find no rationale for this approach. It was decided that the bar should only apply in insolvent liquidations where ordinary creditors had not been paid in full. Where all ordinary creditor claims were met, there was no further need for the protection of the company's capital and hence no need for the rule.

The Priority Issue

The next question was where Misrepresentation Claims should rank in the order of priorities, and whether such claims rank alongside ordinary creditors or are subordinated and ranked as member claims.

The answer to this conundrum required an analysis of whether:

- a Misrepresentation Claim is a claim which is being made by a shareholder in its capacity as a member, in which case it would fall to be a member claim within the meaning of section 49(g) of the Companies Act (2023 Revision) (the **Act**);[5]
- or whether such a claim was being made by a shareholder in a separate capacity, in which case it would be classed as an ordinary creditor claim.

In *HQP*, the Court looked to high Australian authority,[6] which drew a distinction between a claim to recover monies paid under a contract and a claim to recover monies paid to create a contract.

In *Sons of Gwalia*,[7] it was found that a fraudulent misrepresentation that led to subscription monies being paid to create the relationship of member, was a claim to recover monies paid to create a contract. That

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[5] Section 49(g) of the Act, is equivalent to section 74(2)(f) of the Insolvency Act 1986 (UK).

[6] *Sons of Gwalia v Margaretic & Anor* [2007] HCA 1; [2007] 3 LRC 462 (***Sons of Gwalia***).

[7] *Sons of Gwalia*, at [205].

being so, the claim was not made by a shareholder in its character as member, because such claims were not founded upon obligations owed under the statutory contract as the contract was not in existence.

The Court in *HQP* accepted this, and in a pithier expression of principle, found such claims to be a 'pre-contractual tort'[8] i.e. one which occurred before the investor became a member. Accordingly, such claims could not fall under section 49(g) of the Act and must, therefore, be classed as ordinary creditor claims.

Again, the Court in *DLI* differed, finding that Misrepresentation Claims were member claims. This conclusion was reached by analysing the potential damages sought:

- A Misrepresentation Claim would seek compensation for the value of what a shareholder paid on subscription.
- Such a claim would, therefore, be seeking to recover a sum representing a shareholder's capital contribution.
- Not only would such a claim be derived from an investor's position as a shareholder and hence part of the corporate nexus, it would also be a *de facto* claim for the return of capital.

Applying the Rule in *Houldsworth* and the rationale behind it, such a claim could not compete with ordinary creditors. That being so, the claim must be a member claim falling under section 49(g) of the Act.

The Redemption Issue

The Court's final task in DLI was to decide how such Misrepresentation Claims ranked alongside Redemption Claims.

It was not in dispute that whilst a Redemption Claim is a creditor claim in that a debt is owed to a former shareholder by the company, it is also a claim by a former shareholder in its character as a member which falls within the ambit of section 49(g) of the Act.

The Court, therefore, had to consider whether there was anything in law which elevated a Redemption Claim above a Misrepresentation Claim. It was submitted on behalf of the redemption claimants that the Act mandated priority amongst members for Redemption Claims and that this had been confirmed by both the Court of Appeal and Privy Council.

The Court disagreed and found that whilst a redemption claimant was a member creditor (as it was owed a debt for its redemption proceeds), a successful misrepresentation claimant would also be a member creditor (in that it was owed damages for the misrepresentation). Therefore, both would prove in priority to normal shareholders to whom no debt was owed. However, between themselves, they must rank pari passu. Just as ordinary creditors ranked equally regardless of when they become creditors, so too should member creditors.

Current position

So where do things stand? If *HQP* is to be favoured then Misrepresentation Claims may always be admitted and will rank alongside ordinary creditor claims if proved. If *DLI* is to be favoured then Misrepresentation Claims can only be admitted in liquidations once all ordinary creditors are paid and will rank alongside Redemption Claims but above ordinary shareholders. The uncertainty should soon be resolved with an appeal pending in *HQP* where all results are possible, including the imposition of an absolute bar on Misrepresentation Claims and a strict application of *Houldsworth*.

The importance of this appeal may go further than legal clarity. Should the decision in *HQP* be upheld, there may be wider ramifications. *HQP* mirrors the *Sons of Gwalia* decision in Australia which at the time was described as a 'corporate bombshell'.[9]

It was widely believed that the decision would negatively affect the Australian debt market, in that the cost of debt would spiral where lenders were competing with members in a liquidation. It was also believed that it would make liquidations unmanageable due to the potential for large and complex claims clogging the

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[8] *HQP* at [187].

[9] See: 'Court drops corporate bombshell' Leon Gettler, 1 February 2007, *The Age*.

system. Such was the concern, that the Australian legislature passed an act to restore the order of priorities by subordinating Misrepresentation Claims to ordinary creditor claims. Some say the concerns in Australia were overblown and in the three years preceding the legislative change the bombshell did not explode.

However, the possibility of the disruption envisaged in Australia would be extremely unwelcome given the importance of the funds industry to the Cayman Islands. Only time, and the Court of Appeal, will tell what happens next.

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Contacts

Simon Dickson
Partner
Mourant Ozannes (Cayman) LLP
+1 345 814 9110
simon.dickson@mourant.com

Laura Stone
Senior Associate
Mourant Ozannes (Cayman) LLP
+1 345 814 9121
laura.stone@mourant.com

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