IN THE GRAND COURT OF THE CAYMAN ISLANDS

FINANCIAL SERVICES DIVISION

Cause NO. FSD 27 OF 2013 – AJJ

The Hon. Justice Andrew J. Jones QC
In Open Court, 2nd, 3rd & 4th June 2015

IN THE MATTER OF THE COMPANIES LAW (2013 REVISION)

AND IN THE MATTER OF HERALD FUND SPC (IN OFFICIAL LIQUIDATION)

BETWEEN:

PRIMEO FUND (In Official Liquidation) **Plaintiff**

And

MICHAEL PEARSON as Additional Liquidator of Herald Fund SPC (In Official Liquidation) **Defendant**

Appearances: Mr. Michael Crystal QC and Mr. Tom Smith QC instructed by Mr. Peter Hayden, Mr. Rocco Cecere and Mr. Christopher Levers of Mourant Ozannes for the Plaintiff, Primeo Fund (In Official Liquidation)

Mr. Francis Tregear QC instructed by Mr. Matthew Goucke and Mr. Christopher Keefe of Walkers for the Defendant, as Additional Liquidator of Herald Fund SPC (In Official Liquidation)

RULING

Introduction and general factual background

1. By an order made on 24 November 2014 the Court directed, pursuant to Order 11, rule 3 of the Companies Winding Up Rules, that certain issues arising in the liquidation of Herald Fund SPC (In Official Liquidation) ("Herald") be

adjudicated by means of an inter partes proceeding between Primeo Fund (In Official Liquidation) ("Primeo") and the Additional Liquidator of Herald, both acting in representative capacities. The general factual background giving rise to these issues is well known can be briefly summarized as follows.

2. Herald was incorporated as an open ended investment fund on 24 March 2004. From its inception, the whole of its funds (apart from a relatively small amount of cash retained for liquidity purposes) were placed with Bernard L. Madoff Investment Securities LLC ("BLMIS") for investment in a portfolio of securities. In fact, BLMIS was the world's largest Ponzi scheme. This came to light on 11 December 2008 when Mr. Bernard L. Madoff ("Madoff") confessed that BLMIS was an elaborate fraud and he subsequently pleaded guilty to 11 counts of fraud for when he was sentenced to 150 years in prison.

3. Primeo was incorporated on 18th November 1993 and also carried on business as an open ended investment fund. It had placed funds for investment directly with BLMIS since 1993 but, from 2004 onwards, it invested in Herald with the result that it became an indirect victim of the Madoff Ponzi scheme. Primeo was put into voluntary liquidation on 23 January 2009 and its liquidation was brought under the supervision of the Court on 8 April 2009. Herald had suspended the calculation of NAV and the issue and redemption of shares on 12 December 2008 (the day after the revelation of the Madoff fraud) but remained under the control of its directors until 23 July 2013 when a winding up order was made on the petition of Primeo.

The December Redeemer Issue

4. The first issue to be determined in Herald's liquidation is whether section 37(7)(a) of the Companies Law (2013 Revision) applies in relation to the Participating Non-Voting Shares which form the subject of redemption requests submitted to Herald by shareholders for the Redemption Day 1 December 2008 but in respect of which the redemption moneys were not paid to the relevant shareholders ("the December Redeemers"). This is referred to as "the December Redeemer Issue". For the purposes of determining this issue the Court appointed Primeo as representative of (a) those holders of Participating Non-Voting Shares which form the subject of redemption requests for the 1 December 2008 Redemption Day and which shares were redeemed on 1 December 2008 but in respect of which redemption moneys were not paid to the relevant December Redeemers and (b) those holders of shares in Herald who submitted redemption requests to Herald for a Redemption Day prior to 1 December 2008 and which

shares were redeemed but in respect of which redemption moneys were not paid due to outstanding "Know your client" and/or other documentation ("the KYC Redeemers").

Agreed statement of facts relating to the December Redeemer Issue

5. The December Redeemer Issue is to be decided upon the basis of agreed facts but it is not necessary for the purposes of this Ruling that I should recite the Statement of Agreed Facts. I set out below a summary of the most salient points. The use of capitalized words and phrases indicates that they are defined in Herald's articles of association and/or offering memorandum or in the Statement of Agreed Facts and that I am using them as so defined.

6. Redemption requests were received by HSBC Securities Services (Luxembourg) SA ("HSSL"), acting on behalf of Herald in its capacity as administrator, from the December Redeemers requesting the redemption of Participating Non-Voting Shares (the "December Redeemer Shares") for a Redemption Day of 1 December 2008 (being the first Business Day in December 2008). All, or substantially all, of the December Redeemer Redemption Requests were accepted by Herald (including the requests made by Primeo).

7. In accordance with the Articles and Offering Memorandum, the relevant Valuation Point for the Redemption Day of 1 December 2008 was 28 November 2008. In accordance with the Articles and Offering Memorandum, HSSL acting for and on behalf of Herald calculated, and provided the December Redeemers with a NAV per Share for the Valuation Point of 28 November 2008 of US$1,386.20 per USD class Share and €1,328.74 per EUR class Share. As required by and in accordance with the Articles, the December Redeemer Shares were redeemed on 1 December 2008 and removed from Herald's share register by HSSL acting for and on behalf of Herald prior to the commencement of Herald's winding up.

8. In or about June 2011, HSSL acting for and on behalf of Herald subsequently issued documents to all, or substantially all, of the December Redeemers (including Primeo) headed *Confirmation of Redemption*, in respect of each December Redeemer Redemption Request which stated*: "In accordance with your instructions we confirm having REDEEMED the following Shares from HERALD USA SEGREGATED PORTFOLIO ONE ..."* Details of the transactions were set out, including the number of shares redeemed and the amount payable.

9. Upon the redemption of the December Redeemer Shares and the KYC Shares, under Article 22(1) of the Articles, the December Redeemers and the KYC Redeemers were entitled to have the relevant Redemption Proceeds paid to them as soon as reasonably

practicable subject to Herald's ability to suspend payment of such proceeds pursuant to Article 22(1). The Offering Memorandum provides that the payment of redemption proceeds shall generally be made within twenty Business Days of the relevant Redemption Day.

10. On 10 December 2008, prior to the date of suspension, the sum of approximately US$31 million was paid by Herald to one December Redeemer, and this represented the full amount of the December Redemption Proceeds due to that December Redeemer. Herald did not pay any December Redemption Proceeds to the other December Redeemers in respect of their December Redemption Requests.

11. On 11 December 200,8 Madoff confessed that BLMIS was an elaborate fraud. On the following day, 12 December 2008, the directors of Herald resolved to suspend the calculation of the Net Asset Value per Participating Non-Voting Share and the issue, redemption and conversion of Participating non-Voting Shares with immediate effect and until further notice ("the Suspension"). On 24 December 2008, the Directors passed a further circular resolution which stated that –

> *"...to the extent not expressly contemplated by the Suspension, the payment of redemption proceeds to investors in respect of redemption requests in Herald USA for value 26 November 2008 (but in respect of which [Herald] is not ordinarily obliged to pay redemption proceeds until or about 28 December 2008) is hereby suspended with immediate effect and until further notice."*

12. The KYC Redeemers are in the same position as the December Redeemers except that HSSL considered that it should withhold payment of the redemption proceeds, which would otherwise have been payable, pending receipt of information thought necessary to comply with the applicable anti-money laundering procedures. For the purposes of determining the December Redeemers Issue, this is not a material distinction.

13. Section 37 of the Companies Law (2013 Revision) sets out a comprehensive code relating to the issue and redemption of redeemable shares and the purchase by a company of its own shares (including redeemable shares). As Mr Tregear rightly says, section 37 is intended to be a code of general application to all companies. A company cannot contract out of section 37 or adopt articles of association which would have the effect of dis-applying the statutory provisions.

14. Section 37(1) provides that the issue of shares which are to be redeemed or are liable to be redeemed, either at the option of the company or the shareholder, is permitted provided that it is authorized by the company's articles of association.

> *" 37. (1) Subject to this section, a company limited by shares or limited by guarantee and having a share capital may, if authorised to do so by its articles of association, issue shares which are to be redeemed or are liable to be redeemed at the option of the*

company or the shareholder and, for the avoidance of doubt, it shall be lawful for the rights attaching to any shares to be varied, subject to the provisions of the company's articles of association, so as to provide that such shares are to be or are liable to be so redeemed.

(2) Subject to this section, a company limited by shares or limited by guarantee and having a share capital may, if authorised to do so by its articles of association, purchase its own shares, including any redeemable shares."

As can be seen from the provisions of section 37 as a whole, there is no real distinction between a redemption of redeemable shares and the purchase by a company of its own shares, whether or not issued as redeemable shares. In this case, the Court is not concerned with a purchase by the company of its own shares.

15. Section 37(3) provides that shares may not be redeemed unless they are fully paid or if to do so would result in there no longer being any member of the company. By section 37(3)(c) redemptions or purchases may be effected in such manner and upon such terms as may be authorized by or pursuant to the company's articles of association. Where the articles are silent, the manner and terms of a purchase must be authorized by a resolution of the company's shareholders.

16. Section 37(3)(f) provides for shares to be redeemed out of profits or the share premium account or out of a fresh issue of shares. Section 37(5) provides for shares to be redeemed out of capital if so authorized by its articles of association, subject to the company being able to pay its debts as they fall due in the ordinary course of business as required by section 37(6)(a) which provides as follows -

"37 (6)(a) A payment out of a capital by a company for the redemption or purchase of its own shares is not lawful unless immediately following the date on which the payment out of capital is proposed to be made the company shall be able to pay its debts as they fall due in the ordinary course of business."

Section 37(7) says what is to happen in the event that a liquidation proceeding is commenced.

"37.(7)(a) Where a company is being wound up and, at the commencement of the winding up, any of its shares which are or are liable to be redeemed have not been redeemed or which the company has agreed to purchase have not been purchased, the terms of redemption or purchase may be enforced against the company, and when shares are redeemed or purchased under this subsection they shall be treated as cancelled:

Provided that this paragraph shall not apply if –

(i) the terms of redemption or purchase provided for the redemption or purchase to take place at a date later than the date of the commencement of the winding up; or

(ii) during the period beginning with the date on which the redemption or purchase was to have taken place and ending with the commencement of the winding up the company could not, at any time, have lawfully made a distribution equal in value to the price at which the shares were to have been redeemed or purchased.

(b) There shall be paid in priority to any amount which the company is liable by virtue of paragraph (a) to pay in respect of any shares- (i) all other debts and liabilities of the company (other than any due to members in their character as such); and (ii) if other shares carry rights whether as to capital or as to income which are preferred to the rights as to capital attaching to the first mentioned shares, any amount due in satisfaction of those preferred rights, but subject to that, any such amount shall be paid in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members."

17. The issue for the Court's determination is whether the shares which form the subject of redemption requests submitted for the 1 December 2008 Redemption Day and which were redeemed on that day pursuant to Herald's articles should be treated as having "not been redeemed" within the meaning of section 37(7)(a) because the redemption proceeds were not paid and remained outstanding at the commencement of the liquidation.

18. Primeo's submission begins with proposition that the question of when a company's shares are regarded as having been redeemed is answered by reference to the relevant provisions of its articles of association. In light of the Privy Council's decision in *Culross Global SPC Limited v. Strategic Turnaround Partnership Limited* 2000 (2) CILR 364, this is not a controversial proposition. Lord Mance said (at paragraph 8) –

"It is a basic principle of company law that capital subscribed to a company may not be redeemed to shareholders otherwise than as prescribed by statute. Section 37(1) of the Companies Law permits the issue by a company of shares liable to be redeemed at the option of the company or the shareholder, and s.37(3)(c) goes on to provide that 'redemption of shares may be effected in such manner as may be authorized by or pursuant to the company's articles of association'. It is uncontroversial that this means that the manner in which any redemption may be effected must be authorized by or pursuant to the articles of association."

The manner in which Herald's Participating Non-Voting Shares are to be redeemed is set out in Articles 20-23. It is not necessary to set out the relevant provisions because it is agreed that their effect is that the December Redeemers' shares were redeemed on the 1 December 2008 Redemption Day.

19. The second leg of Primeo's argument is that, by its terms, sub-section (7)(a) applies only to shares which have *not* been redeemed as at the commencement of the winding up. It follows, according to Mr Crystal, that sub-section (7) can have no application to the December Redeemers, including Primeo itself, because their shares were redeemed on 1 December 2008, which was several years before the commencement of Herald's liquidation. I agree with this analysis.

20. In the context of redemption (as opposed to purchase), sub-section (7) contemplates two different scenarios. First, it applies in the case of shares which "are to be redeemed" but have not been redeemed. The example given is the case in which a company's shares are required to be redeemed on a fixed date. Second, it applies in the case of shares which "are liable to be redeemed", but have not been redeemed. The example given is the case in which a valid redemption notice has been served but the steps required by the articles of association to be undertaken in order to complete the process of redemption have not been completed prior to the commencement of the liquidation. Construed in this way, the purpose and effect of sub-section (7)(a) is clear. An obligation to redeem shares (arising in accordance with the company's articles of association) can be enforced against the company in liquidation unless enforcement is disallowed by the application of provisos (i) or (ii). The effect of sub-section (7)(b) is that a shareholder who becomes a creditor by virtue of being able to enforce his right of redemption under paragraph (a), is subordinated to the ordinary creditors (whose debts are not due to them in their character as shareholders) but ranks ahead of the shareholders who do not have enforceable rights of redemption.

21. In light of the Privy Council's decision in *Strategic Turnaround*, Mr Tregear is bound to accept that the December Redeemers' shares were redeemed on 1 December 2008, but he makes the point that the Privy Council was only concerned in that case with the question whether redemption had taken place in accordance with the articles of association and did not address the meaning of "redemption" as used in sub-section (7) which he says is "all about payment of the redemption proceeds".

22. In *Strategic Turnaround* the plaintiff shareholder had served a valid redemption notice. After the redemption date had passed, the company declared a suspension of redemptions and refused to pay the redemption proceeds. The plaintiff then presented a creditor's winding up petition and the issue for determination was when redemption had taken place. Lord Mance said at paragraph 16 –

> *"The issue depends, in the Board's view, upon the construction of the appellant's articles, read with such other documents as may be incorporated or referred to therein. The existence and extent of any power to suspend the payment of redemption proceeds after the redemption date is a subject upon which the members were at liberty to make "any contract inter se which they pleased" as the Earl of Selborne, L.C. said in Walton v Edge (1884) 10 App Cas 33, 35 with regard to an issue regarding the effect of a provision allowing a member of a building society "to withdraw (provided the funds permit..... by giving" either seven days' or one month's notice according to the amount. The discussion of the concept of redemption in the Australian case of In Re HIH Insurance Ltd. (In Liquidation) [2008] FCA 623, to which the respondent referred the Board, took place in a very different context to the present, and cannot obviate the need for a detailed examination of the Appellant's articles and documentation to answer the present issue. The issue is not to be approached on the basis of any a priori view that, until payment of the redemption proceeds, a shareholder must or should necessarily remain a member*

of a company which is (as the Respondent was) due to make such payment upon or after a certain redemption date; and the fact that a person's name continues to remain on a company's register as member does not mean that it should have done so under the provisions of the Articles: see e.g. Reese River Silver Mining Company Ltd. v. Smith (1869) 4 HL 64, 80; Michaels v Harley House (Marylebone) Ltd. [1997] 2 BCLC 166, 174."

23. The applicable articles in *Strategic Turnaround* are similar to those of Herald. Lord Mance said at paragraph 20 –

> *"The focus of these provisions is on the Redemption Date by reference to which the Redemption Price payable is crystallised and from which the Price is deemed to be a liability of the Respondent. The remittance of the "redemption proceeds" is treated as a matter of supplementary procedure, although it may be refused on particular money-laundering grounds. Both stages may be said to be part of a continuing process, but it does not follow that "redemption" within the meaning of articles 55 and 32 only occurs at the conclusion of that whole process. Nor, in the Board's view, can article 40 assist on the question of what constitutes redemption under articles 55 and 32, as the Court of Appeal (in para 52 of its judgment) thought Article 40 is largely neutral as to the date at which "a share is redeemed," at which the member ceases to be entitled to any rights, except a dividend "declared prior to such redemption," and at which the member's name falls to be removed from the register in respect of the share and the share is available for re-issue."*

24. The Privy Council therefore concluded that the power to suspend redemption did not apply as against the plaintiff because the redemption had already taken place. The Chief Justice applied the same reasoning in *RMF Market Neutral Strategies (Master) Limited v. DD Growth Premium 2X Fund* (Unreported, 17 November 2014). This was another case involving an open ended investment fund whose articles of association were similar to those of Herald. The Chief Justice concluded that the effect of the articles was that upon service of a valid redemption notice, the shares in question ceased to be outstanding on the relevant valuation day, whereupon the shareholder became a creditor in respect of the redemption proceeds. The Chief Justice said (at paragraphs 26 and 29) –

> *"26. Therefore under the Articles, a shareholder who had submitted a valid redemption request became a creditor of the company for the amount owed under the Articles on the day following the Valuation Day. That this is the proper construction of the Articles which are expressed in such terms, was accepted in the arguments before me and, as a matter of legal construction, settled by the Privy Council in Culross Global SPC Limited v Strategic Turnaround Master Partnership Ltd 2010 (2) CILR 364."*

> *"29. In accordance with the construction of the Articles as outlined above, the shares of all seven December redeemers ceased to be outstanding at the close of business on the Valuation Day (Friday 28 November 2008) and as of 29 November 2008, the December redeemers became creditors of the 2X Fund for whatever they were entitled to receive on redemption..."*

25. A similar argument was considered by the Eastern Caribbean Supreme Court in *Western Union International Limited v. Reserve International Liquidity Fund Ltd* [2010] ECSCJ No.26. Reserve was incorporated in the British Virgin Islands and carried on business as a money market fund. On 15 September 2008, it was announced that Lehman Brothers had filed for bankruptcy in the United States. It was accepted that Western Union had served a redemption request which was accepted by the Fund for payment at the NAV calculated as at the close of business on that day. Subsequently, on 23 September 2008, the fund's directors passed a resolution purporting to suspend redemptions as of 16 September 2008. Western Union was not paid and claimed in the Fund's liquidation as a creditor. The issue was whether a redeeming member fell under the applicable British Virgin Islands statutory provision which prohibited a member from ranking in the liquidation as an unsecured creditor for sums due to it *as a member*. The Court rejected the argument that the redemption process was incomplete because payment of the proceeds had not been made. Bannister J said (at paragraph 9) –

> *"The fact that redemption proceeds have not been paid does not, in my judgment, mean that the shares have not been redeemed, nor does it mean, as submitted by [counsel for the Fund] that the redemption process is incomplete, except in the sense that [Western Union] remains unpaid. The redemption was complete when [the Fund] accepted the request on 15 September 2008. The fact that [Western Union] has yet to receive the redemption proceeds has no bearing on that fact."*

Since the redemption had been completed in accordance with the Fund's articles, it followed that Western Union was claiming as a creditor and not as a member.

26. Mr Tregear's proposed construction of sub-section 7(a) is not consistent with these decisions. However, I should mention that, after the conclusion of the argument, I was referred to a decision of Foster J. in *Re Founding Partners Global Fund Ltd (In Liquidation)* (Unreported, 21 September 2010). In that case the Fund's articles provided for its assets to be segregated amongst different share series and the issue was whether an unpaid redeemed shareholder's creditor claim was limited to a claim against the segregated assets attributable to the share series in question or was a claim against the assets of the Fund as a whole. The answer to this question did not turn on the application of section 37(7)(a) but the judge referred to it in the context of what had been agreed between the parties. He said "[i]t was agreed that the wording of sub-paragraph (a) is not as clear as it might be but that the words '*...have not been redeemed'* must mean '*the redemption proceeds due have not been paid'*". Since the point had been agreed and was therefore not subject to argument, the Judge's observation cannot be regarded as authority supporting Mr Tregear's argument.

27. The word "redemption" is used repeatedly throughout section 37. The legislature must be taken to have used the word consistently. Sub-section (3)(c) expressly

provides that redemption occurs "in such manner and upon such terms as may be authorized by or pursuant to the company's articles of association". The meaning of "redemption" as used in sub-section (3)(c) is plain. There is no reason to infer that the legislature intended to attribute a different, extended meaning to the word "redemption" when it is used in sub-section (7)(a). If "redemption" has taken place in accordance with sub-section (3)(c), then "redemption" must also have taken place for the purposes of sub-section (7)(a). If the legislature had intended to use the word "redemption" in these closely related sub-sections in two quite different ways, it would have said so expressly. The context in which the word "redemption" is used in sub-section (7)(a) does not suggest that the legislature must have intended it to have an extended meaning which is different from the meaning used in sub-section (3)(c). It makes perfectly good sense to give the word "redemption" the same meaning in both sub-sections.

Conclusion

28. I have come to the conclusion that the December Redeemer Issue should be decided in favour of those whom Primeo represents. I will therefore make a declaration that, on the basis of the agreed facts, section 37(7)(a) does not apply to the Participating Non-Voting Shares which form the subject of redemption requests submitted to Herald by shareholders for Redemption Day 1 December 2008 but in respect of which the redemption moneys were not paid to the relevant December Redeemer. I reach the same conclusion in respect of KYC Redeemers who submitted redemption requests for earlier redemption days but in respect of which payment of the redemption proceeds was withheld.

The Rectification Issue

29. The second issue to be determined is (a) whether the NAVs determined pursuant to the Articles during the period from 24 March 2004 (being the date of its incorporation) to 10 December 2008 (being the date immediately before the revelation of the Madoff fraud) in respect of each class of Participating Non-Voting Shares issued by Herald are not binding on Herald by reason of "fraud or default" within the meaning of section 112 of the Companies Law and Order 12, rule 2 of the Companies Winding Up Rules and (b) whether section 112 of the Companies Law and/or Order 12, rule 2 of the Companies Winding Up Rules apply so as to require or empower the Additional Liquidator of Herald to rectify its register of members. These are referred to as "the Rectification Issues". For these purposes Primeo was appointed to represent the class of investors arguing that the issues be answered in the negative and the Additional Liquidator of Herald was appointed to represent those arguing that the issues be answered in the affirmative.

30. Section 112 of the Companies Law provides as follows :-

> *"112. (1) The liquidator shall settle a list of contributories, if any, for which purpose he shall have power to adjust the rights of contributories amongst themselves.*
>
> *(2) 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.*
>
> *(3) A contributory who is dissatisfied with the liquidator's determination may appeal to the Court against such determination."*

31. The Insolvency Rules Committee has power to "make rules and prescribe forms for the purpose of giving effect to", inter alia, Part V of the Companies Law which includes section 112. The Committee has exercised this power in respect of section 112 by making Order 12 of the Companies Winding Up Rules, rule 2 of which provides as follows –

> "2. (1) *The official liquidator shall exercise his power to rectify the company's register of members under section 112(2) if he is satisfied that –*
>
> *(a) the company is or will become solvent;*
>
> *(b) the company has from time to time issued redeemable shares at prices based upon a mis-stated net asset value which is not binding upon the company and its members by reason of fraud or default, with the result that the company has issued an excessive or inadequate number of shares in consideration for the prices paid by one or more subscribers; and/or*
>
> *(c) the company has redeemed shares at prices based upon a mis-stated net asset value which is not binding upon the company and its members by reason of fraud or default, with the result that the company has paid out excessive or inadequate amounts to former members in consideration for the redemption of their shares.*
>
> *(2) Subject to paragraph (3), for the purposes of rectifying the register of members in accordance with this Rule, the official liquidator shall determine the true net asset value of the company as at each relevant redemption date.*
>
> *(3) The true net asset value of the company shall be determined in accordance with the accounting principles specified for this purpose in its articles of association or, if none are specified, in accordance with whatever generally accepted accounting principles are adopted by the official liquidator.*
>
> *(4) The register of members, when rectified by the official liquidator in accordance with section 112(2) of the Law, shall state, as at each relevant redemption date –*

> (a) *the identity of each subscriber, the amount of money subscribed and the number of shares which ought to have been issued to him (applying the true net asset value per share);*
>
> (b) *the identity of each member who redeemed shares, the number of shares redeemed and the amount of redemption proceeds which ought to have been paid to him (applying the true net asset value per share);*
>
> (c) *the identity of the company's members and the number of shares which ought to have been held by each member, had the subscriptions and redemptions been done at the true net asset value per share, and the company's share register shall be rectified accordingly.*
>
> (5) *If the official liquidator considers that it will be impractical or not cost effective to rectify the company's register of members in accordance with paragraphs (2) and (3) of this Rule, he shall nevertheless rectify the register in such manner which is both cost effective and fair and equitable as between the shareholders.*"

I shall refer to this rule simply as "Rule 2".

32. Section 112(2) empowers an official liquidator to rectify the register of members in the case of a solvent company which has issued redeemable shares at prices based upon its net asset value from time to time. Rule 2 provides that the official liquidator shall exercise the statutory power of rectification where shares have been issued and/or redeemed at prices based upon mis-stated NAVs which are not binding upon the company and its members by reason of fraud or default. The first point which arises is whether, on its true construction, the application of Rule 2 is limited to circumstances in which the NAVs are not binding as a matter of contract pursuant to the articles of association. The Additional Liquidator's case is that a determination of a NAV which is mis-stated by reason of fraud or default is not binding by operation of the rule itself, with the result that one does not need to go on to ask whether or not it would be contractually binding in accordance with the company's articles of association. I do not accept this argument because it is inconsistent with the plain language of the rule and would produce results which cannot have been intended by the rule making authority.

33. The requirement that the NAVs not be binding between the company and its members means that there must be some conduct on the part of the company itself or conduct on the part of an agent which can properly be imputed to the company which has the effect of vitiating the contract with its members. The mere fact that the determination of the Herald's NAVs was affected by the fraud of BLMIS is not by itself sufficient to vitiate the contract. The point is illustrated by the decision of the Privy Council in *Fairfield Sentry Ltd v. Migani* [2014] UKPC 9, the facts of which are very similar to the present case. Fairfield Sentry Ltd was an open ended investment fund established

under the laws of the British Virgin Islands. As in the case of Herald, the whole of its invested assets were placed for investment with BLMIS and so it became another victim of the Madoff Ponzi scheme. Its liquidators commenced proceedings to recover amounts paid out on redemption to a number of shareholders and former shareholders prior to the discovery of the fraud on the footing that they were paid in the mistaken belief that the Fund's assets were as stated by BLMIS. The Privy Council upheld the dismissal of the liquidators' claim.

34. Lord Sumption began his analysis of the law (at paragraph 17) by making the point that the availability of a claim for restitution arising out of a transaction governed by the articles of a company is governed by the same law which governs the articles themselves, which in the case of Fairfield Sentry Ltd was the law of the British Virgin Islands. He went on to say that in all relevant respects, the principles of British Virgin Islands law governing the construction of the articles and any associated common law right to restitution are the same as English law. This is equally true of Cayman Islands law. He then set out the applicable principles as follows –

> "*18. The basic principle is not in dispute. The payee of money "cannot be said to have been unjustly enriched if he was entitled to receive the sum paid to him": Kleinwort Benson Ltd v Lincoln City Council [1999] 2 AC 349 at 408B (Lord Hope). Or, as Professor Burrows has put it in his Restatement of the English Law of Unjust Enrichment (2012) at 3(6), "in general, an enrichment is not unjust if the benefit was owed to the defendant by the claimant under a valid contractual, statutory or other legal obligation." Therefore, to the extent that a payment made under a mistake discharges a contractual debt of the payee, it cannot be recovered, unless (which is not suggested) the mistake is such as to avoid the contract: Barclays Bank Ltd v W.J. Simms Son & Cooke (Southern) Ltd [1908] QB 677, 695. So far as the payment exceeds the debt properly due, then the payer is in principle entitled to recover the excess.*
>
> *19. It follows that the Fund's claim to recover the redemption payments depends on whether it was bound by the redemption terms to make the payments which it did make. That in turn depends on whether the effect of those terms is that the Fund was obliged upon a redemption to pay (i) the true NAV per share, ascertained in the light of information which subsequently became available about Madoff's frauds, or (ii) the NAV per share which was determined by the Directors at the time of redemption. If (ii) is correct then, the shares having been surrendered in exchange for the amount properly due under the Articles, the redemption payments are irrecoverable. ….*"

35. The conclusion was that on a true construction of the articles, which were not materially different from Herald's articles in this respect, the determination of the NAV by the directors, acting in good faith, was intended to be definitive. The

liquidators' argument that the articles could be interpreted in a way which meant that the directors' determination of NAV was always open to change in the light of subsequent events was dismissed as an impossible construction. Lord Sumption said:

> *"23. In the Board's opinion, this is an impossible construction. If it were correct, an essential term of both the subscription for shares and their redemption, namely the price, would not be definitively ascertained at the time when the transaction took effect, nor at the time when the price fell to be paid. Indeed, it would not be definitively ascertained for an indefinite period after the transaction had ostensibly been completed, because unless a certificate was issued it would always be possible to vary the determination of the NAV per share made by the Directors at the time and substitute a different one based on information acquired long afterwards about the existence or value of the assets. This would not only expose Members who had redeemed their shares to an open-ended liability to repay part of the price received if it subsequently appeared that the assets were worth less than was thought at the time. It would confer on them an open-ended right to recover more (at the expense of other Members) if it later appeared that they were worth more. Corresponding problems would arise out of the retrospective variation of the Subscription Price long after the shares had been allotted. Indeed, it is difficult to see how the Directors could perform their duty under Article 9(1)(b) not to allot or issue a share at less than the Subscription Price if the latter might depend on information coming to light after the allotment had been made."*

36. By parity of reasoning, I think that it is highly improbable that Rule 2 was intended to operate in way which would make the determination of a company's NAV open to challenge whenever it could be said, with the benefit of hindsight, that it had been mis-stated by reason of the fraud or default in some way which would not have the effect of vitiating the contract.

37. It is relevant to bear in mind that Rule 2 is mandatory. It provides that the official liquidator "shall" rectify the register when the applicable criteria are met. If the company's determination of the NAVs is not binding in accordance with its articles, thus giving rise to the possibility of multiple actions by shareholders, it would make sense to impose upon the official liquidator a duty to exercise the power arising under section 112(2) as a means of achieving a rectification binding upon all the shareholders in an orderly way. If the shareholders have no contractual cause of action, there is no reason why the official liquidator should be forced, irrespective of the circumstances, to exercise his power of rectification.

38. Having decided the point of construction against the Additional Liquidator, he argues that Rule is 2 is engaged because the mis-stated NAVs are not binding upon the company and its members in accordance with the articles for two reasons. First, it is said that there was a chain of delegation as between Herald and HSSL and a chain of

delegation and/or reliance between HSSL and BLMIS which leads to the conclusion that HSSL was liable for the fraud of BLMIS as if that fraud were its own. Second, it is said that the determination of the NAVs is not binding because of a manifest error on the face of the relevant documents by which it was certified each month.

39. Turning to the first of these arguments, the starting point is the Administration Agreement between Herald and HSSL, which contains the following terms –

> *"Clause 1.1 – 'Share Prices' shall mean the net asset value, net asset value per share, subscription and redemption prices of shares of the Company.*
>
> *Clause 4 – During the course of this Agreement the Administrator shall ... (q) subject to clause 9 of this Agreement determine in the name of and on behalf of the Company in respect of the Fund on each Valuation Day the Share Prices in accordance with the Articles and in accordance with the information supplied to it by the Manager, the Company and the Custodian;*
>
> *Clause 5 – In the performance of its duties hereunder the Administrator shall at all times be subject to the control of and review by the Manager on behalf of the Fund and the Directors of the Company and shall in all respects observe and comply with the Articles .... and shall well and faithfully serve the Company and use all reasonable endeavours to promote the interests thereof....;*
>
> *Clause 8(b) – The Administrator may – at its own expense employ servants or agents in the performance of its duties and the exercise of its rights hereunder;*
>
> *Clause 8(c) – The Administrator may – delegate its functions, powers, discretions privileges and duties hereunder or any of them to such person, firm or company on such terms and conditions as are agreed between the Administrator and the Company;*
>
> *Clause 9.6 - In calculating the Share Prices, the Administrator shall use reasonable endeavours to verify pricing information supplied by the Manager, any investment adviser or any connected person thereof (including a connected person which is a broker, market maker or intermediary)."*

40. It is also relevant at this point in the argument to look at Article 18(f) which provides that-

> *"any valuations made pursuant to these Articles shall be binding on all persons and the Directors may exercise their reasonable judgment in determining the value of the assets and liabilities hereunder and provided they act bona fide in the best interests of the Company as a whole when conducting such valuations, shall not be open to challenge by current or previous Shareholders;"*

41. Herald and HSSL also entered into a Custodian Agreement pursuant to which HSSL was appointed to hold all of Herald's securities and cash. By clause 15.2, HSSL was entitled to appoint a sub-custodian. HSSL entered into two Sub-Custody Agreements with BLMIS. All these agreements are expressed to be governed by Luxembourg law. The effect of this arrangement was that HSSL transferred all Herald's cash, except for a small amount retained for liquidity purposes, to BLMIS, which contracted to hold Herald's assets in a segregated account but never in fact did so. HSSL determined the NAVs as agent for Herald. It doing so, it was entitled to act on information supplied by BLMIS, but it is said that there was, or may have been, default on the part of HSSL in failing to properly verify that information in accordance with clause 9.6 of the Administration Agreement. By clause 15.2 of the Custodian Agreement, HSSL "will remain responsible to the Fund for any acts or omissions of any Correspondent" which includes BLMIS. In this way it is said that there was a chain of delegation between Herald and HSSL and a chain of reliance between HSSL and BLMIS which leads to the conclusion, or is capable of leading to the conclusion that there was default on the part of HSSL which would vitiate the contract between Herald and its members.

42. In my view this analysis is flawed. Even if it can be established (as between Primeo and the Additional Liquidator and those whom they represent) that HSSL acted in breach of contract, the effect of Article 18(f) is that the resulting NAV determinations are still binding as between Herald and its shareholders with the meaning of Rule 2 unless the directors were acting in bad faith. No such allegation is being made against these directors. I should perhaps add that the directors were "independent" in the sense that they were not employees of either HSSL or BLMIS.

43. Mr Tregear's final point is that the certification of the NAVs was not binding upon Herald and its members within the meaning of Rule 2 by reason of manifest errors on the face of the relevant documentation resulting from the fraud of BLMIS. This argument is founded upon a passage at page 20 of the Offering Memorandum which states that "Any certificate as to Net Asset Value given in good faith (and in the absence of negligence or manifest error) by or on behalf of the Directors shall be binding on the parties." It is then said that this statement is incorporated into Herald's articles of association by Article 18(d) which provides that "the assets of the Segregated Portfolio shall, unless the Directors determine otherwise, be valued in accordance with the relevant Offering Memorandum". Even if I accept that this statement (to the extent that it relates to manifest error) is incorporated into the articles on the basis that it is not inconsistent with the articles and that certification is the final step in the process of valuation, I fail to see how it can have any application upon the agreed facts in this case. Assuming the articles are construed so as to provide that HSSL's certification of the NAV is binding upon Herald and its

members in the absence of manifest error, this means that the error must be obvious and easily demonstrable without extensive investigation at the time the certificates were given. (See *IIG Capital LLC v. Van Der Merve* [2008] 1 All ER (Comm) 435, per Lewison J. at paragraphs [51] and [52] which was approved on appeal [2008] 1 All ER (Comm) 1185 at paragraph [35].)

44. However, on the basis of a statement made by Sir Andrew Morritt in *North Shore Ventures Ltd v. Anstead Holdings Inc* [2011] 3 WLR 628 at paragraph [53], Mr. Tregear argues that the error does not have to be obvious or manifest at the time the certificates are given and so each and every monthly certification of Herald's NAV was not binding because it can be said, with the benefit of hindsight, that they were manifestly wrong because BLMIS was a Ponzi scheme. In my view this analysis is wrong and represents a misunderstanding of what Sir Andrew Morritt meant when he said "I can see no reason why the error must be manifest at the time of the certificate". The *North Shore Ventures* case concerned the certification of the amount of interest payable under a loan agreement. One of the issues was whether or not a purported variation of the interest terms in the loan agreement was binding upon the parties. The certificate in question was prepared on the basis of the original (unvaried) terms as to interest but the court subsequently held that the variation (which resulted in a materially lower interest charge) was binding and enforceable with the result that the amount certified was manifestly wrong. Smith LJ explained the point at issue in paragraph [61] as follows –

> *"On reflection I have come to the conclusion that for a party to rely on a manifest error in a certificate does not depend upon his ability to demonstrate the error immediately and conclusively. In the present case, the guarantors were able to recognize immediately that the certificate was based upon the interest rates as set out in the original loan agreement and not as varied in November 2004. They could see that it was manifestly incorrect. They could not immediately demonstrate that conclusively; they could not do so until the court had determined the issue of variation. But they were right, as this court has now held. I would hold that the certificate was manifestly incorrect and was of no effect."*

45. The facts of the present case are wholly different. In *North Shore Ventures*, it was obvious to the parties at the time the certificate was issued how the certified amount of interest had been calculated and it was obvious at that time that it would be wrong if the variation of the agreement was binding and enforceable. In other words, the error (if there was an error) was obvious on the face of the certificate at the time of its issue. Whether or not there was an error turned on the subsequent resolution of the contractual issue between the parties. On the facts of Herald's case, the position of the parties was wholly different. There was nothing on the face of the certification documents to suggest that the amount of the NAV must have been mis-stated or erroneous. This only became obvious to the parties after they learned about the Ponzi

scheme. In my view the contention that the NAVs are not binding by reason of manifest error is wholly untenable on the agreed facts in this case.

46. For these reasons it cannot be said that the NAVs determined pursuant to Herald's articles of association are "not binding upon the company and its members" within the meaning of Rule 2. It follows that the Additional Liquidator has no duty to rectify Herald's register of members pursuant to Rule 2.

47. I now go on to consider whether the Additional Liquidator can properly exercise the power of rectification created by section 112(2) even though Rule 2 is not engaged. Primeo's case is that it is implicit that if the conditions specified in Rule 2 are not satisfied, the Additional Liquidator should not exercise the power. However, it seems to me that the existence of a rule which imposes a duty to exercise a statutory power in a particular circumstance, does not necessarily lead to the conclusion that it is the only circumstance in which the power ought to be exercised or is capable of being exercised. The language used in section 112(2) is unqualified. It does not contain anything to suggest that the power of rectification is limited to the one specific scenario stated in Rule 2. If the scope of the power was intended to be limited in this way, one would have expected the draftsman to have said so in the statute itself.

48. Rectification of Herald's register in order to do justice amongst those recorded as members as at the commencement of the liquidation would not be inconsistent with the policy considerations expressed by Lord Sumption in *Fairfield Sentry*. There are obviously sound reasons why a company and its shareholders should be allowed to agree that throughout its trading life the directors' determination of the NAV shall be binding so long as they are acting in good faith, but it seems to me that different policy considerations come into play after the commencement of a compulsory winding up proceeding. It seems to me that Section 112(2) contemplates the possibility of rectifying the register, if necessary, to eliminate or ameliorate the consequences of both "internal" and "external" fraud. Rule 2 sets out what must happen in the case of internal fraud or default having the result that the issue and/or redemption of shares is not binding on the company and its members. It leaves open what is to happen in the case of "external fraud" which has the result that issues and/or redemptions of shares based upon mis-stated NAVs are nevertheless binding upon the company and its members as a matter of contract. Empowering the official liquidator to rectify the register only amongst those who are shareholders as at the commencement of the liquidation does not give rise to commercially unacceptable results of the kind described by Lord Sumption in *Fairfield Sentry*. A rectification of the register pursuant to section 112(2) would not have any effect upon the December Redeemers, for example, who are entitled to prove in the liquidation as creditors.

Conclusions

49. Section 112(2) empowers an official liquidator to rectify the register of members 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. As a practical matter, this power is likely to apply only to companies which have carried on business as mutual funds pursuant to the Mutual Funds Law. It is not necessary for the purposes of this case to determine the full scope and limits of the power. Suffice it to say that it is exercisable in circumstances where it is necessary to rectify the register in order to do justice amongst those recorded as shareholders as at the commencement of the liquidation, in circumstances where shares have been issued and/or redeemed at mis-stated NAVs by reason of fraud, notwithstanding that the determination of the NAVs is contractually binding upon the shareholders in accordance with the company's articles of association. On its true construction, section 112(2) empowers the court, acting through its official liquidator, to override the contractual rights of the shareholders when necessary, in order to achieve substantial justice amongst the shareholders. Whether or not the Additional Liquidator of Herald should exercise this power is a matter for determination at the next hearing.

50. Rule 2 requires that the official liquidator *shall* exercise the power of rectification arising under section 112(2) in circumstances where shares have been issued and/or redeemed at prices based upon mis-stated NAVs which are not binding upon the company and its members by reason of fraud or default. Upon its true construction, the duty to rectify the register under Rule 2 would only arise if the Additional Liquidator can establish that the determination of the NAVs in question are not binding in accordance with the company's articles of associations by reason of fraud or default which is properly imputed to the company as a matter of general law. The Additional Liquidator has not established, on the basis of the Statement of Agreed Facts, that Rule 2 is engaged.

51. The statutory power created by section 112(2) is a power to rectify the register. It does not enable the Additional Liquidator to impose upon Herald's shareholders a scheme of distribution which is inconsistent with the requirements of section 140(1) of the Companies Law. In other words, the distribution methodology is fixed by the statute, but it is left to the official liquidator to determine what rectification methodology (and associated valuation methodology) is most appropriate to achieve the object of rectifying the register in the circumstances of the particular case. The object of a rectification of Herald's register of members would be to produce what can properly be regarded as a true register, which eliminates the effect of BLMIS' fraud amongst those recorded as shareholders as at the commencement of the liquidation. The process of rectification therefore involves re-stating the number of

shares which ought to have been issued or redeemed if the transactions had been done at a true NAV. This is done with the benefit of hindsight in accordance with whatever valuation methodology is appropriate having regard to the particular circumstances of the case.

52. Section 112(2) applies to empower the Additional Liquidator to rectify Herald's register of members amongst those on the register as at the commencement of the liquidation. Whether or not the Additional Liquidator should exercise the power and, if so, what rectification methodology (and any associated valuation methodology) should be adopted will be determined at the next hearing.

Orders accordingly.

DATED this 12th day of June 2015

GRAND COURT CAYMAN ISLANDS

The Hon. Justice Andrew J. Jones, QC
JUDGE OF THE GRAND COURT