

Ranking of redemption proceeds in a Cayman liquidation

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The Privy Council has provided important clarity in recent years on the rights of redeeming investors of Cayman funds in liquidation.

In their judgment delivered on 6 July 2017, the Privy Council affirmed the decision of the Cayman Islands Court of Appeal in *In Michael Pearson (as Additional Liquidator of Herald Fund SPC (In Official Liquidation)) v Primeo Fund (In Official Liquidation)*¹ that, while "the path to redemption is not always smooth"^[1] it is now well settled as a matter of Cayman Islands law that:

- shareholders who redeem their shares in accordance with a company's articles of association prior to the company being placed into liquidation should be considered as redeemed even though not yet paid, and therefore they rank as creditors;
- redemption creditors' claims are founded on the statutory contract between them as members and the company, and as such their claims are in their "character of a member" and therefore they rank behind the company's external unsecured creditors, but ahead of the company's unredeemed shareholders; and
- as creditors the redeemers are entitled to enforce their right to payment notwithstanding the fund in question being insolvent at the date of redemption.

Background

Herald Fund SPC ("**Herald**"), was a Madoff feeder fund, registered as a Cayman Islands exempted segregated portfolio company. Primeo Fund ("**Primeo**"), also a Cayman fund, was a shareholder in Herald.

In late 2008 Herald received redemption requests from a number of shareholders, including Primeo (the "**Redeemers**"), and in accordance with Herald's Articles of Association, the Redeemers' names were removed from Herald's share register on 1 December 2008.

On 12 December 2008, the day after Madoff's admission and the fraudulent scheme came to light, Herald's board suspended the calculation of the NAV and the issue and redemption of shares until further notice. As a result, the redemption proceeds payable to the Redeemers were not paid.

Reichmuth & Co appeared as an intervener before the Privy Council representing investors referred to as the "Late Redeemers", who had given notice of their intention to redeem before the suspension date, but whose redemption day had not yet passed.

Natixis SA appeared as a second intervener before the Privy Council, representing investors referred to as the "Later Redeemers" who did not submit redemption requests until after the suspension date.

The Redeemers and the Late Redeemers claimed they were entitled to receive the redemption proceeds as creditors and that their claims to payment were to be treated *pari passu* with Herald's other creditors and ahead of Herald's other shareholders who had not redeemed their shares prior to the suspension.

The liquidators of Herald, supported by the Later Redeemers, took the position that section 37(7)(a) of the Companies Law applied to the claims of the Redeemers and that, under the provisos to that section, they had no entitlement to enforce their claim to the redemption proceeds as creditors, meaning that they would rank as contributories, equally with the unredeemed shareholders and behind all other creditors.

Relevant law

Section 37(7) states:

(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.....the terms of redemption ... may be enforced against the company, and when shares are redeemed ... under this subsection they shall be treated as cancelled" (underline added).

The meaning of the underlined phrase was the subject of the appeal, as will be discussed below.

The provisos to this section provide that this right to enforce redemption rights does not apply if:

"The terms of redemption or purchase provided for the redemption or purchase to take place at a date later than the date of commencement of the winding up" ie where the

redemption date under the Articles has not passed at the date the company went into liquidation;

Or...

"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" i.e. the company could not, as at the redemption date, have lawfully paid the redemption because it was insolvent (unable to pay its debts as they fell due).

If the provisos do not apply and the redemption right is enforceable, section 37(7) (b) provides that the redeemed investor ranks behind the company's other unsecured creditors but ahead of unredeemed members.

The Decision

The application of section 37(7) (a) to unpaid redeemers was important because if it applied, it potentially brings into effect the provisions of 37(7) - the relevant provision in this case being that if the fund was insolvent at the redemption date (as Herald was), the right to payment of the redemption proceeds falls away. Both Herald and the Later Redeemers would, therefore, have ranked *pari passu* with both Primeo and the Late Redeemers.

It is now beyond debate in the Cayman Islands that s37(7) (a) does not apply to those who had redeemed but remained unpaid at the commencement of the winding up. Jones J. found at first instance (and the Court of Appeal and Privy Council agreed) that the phrase "have not been redeemed" could not apply where the redemption date has passed prior to the commencement of the winding up, because, as held by the Privy Council in *Culross Global SPC Ltd v Strategic Turnaround Master Partnership Ltd* (2010) (2) CILR 364, on that date the debt crystallises, the redeemer ceases to be a member and becomes a creditor, and has fully redeemed even though they may still be awaiting payment. The Privy Council highlighted (at [13]) that:

"In the Board's opinion, payment is, as a matter of general principle, clearly not an inherent element of the redemption or purchase by the company of its own shares. The provision in the articles for its deferral for a short time was, no doubt, a convenience to the company. The essence of redemption is, however, the surrender of the status of shareholder, with all attendant rights, just as the essence of purchase is the transfer of property. If this occurs, the referral of payment of the price is no more than a grant of a short period of creditor to the company, without any reservation of property or interest." [2]

The Board further concluded that:

1. at the commencement of a company's winding up, section 37(7) (a) did not apply where redeemable shares had been redeemed according to the company's Articles of Association, notwithstanding that the company was still to make payment of the redemption proceeds; and
2. section 37(7) (a) applied where "redemption or purchase ought to have been, but was not, effected by the company before the commencement of the winding up, and allows the relevant shareholder to enforce the terms of redemption or purchase notwithstanding the winding up"[3] while also recognizing that "the likelihood in practice of successful section 37(7) claimants may well also be slight"[4] ".

Following the determination of the Privy Council, it is now clear that in the context of a Cayman Islands liquidation, proceeds shall be distributed in the following order of priority:

- a. First, debts owing to third party 'outsider' unsecured creditors;
- b. Then, to members to whom the company has accrued liability in their capacity as members[5] - this includes unpaid redemption proceeds and declared but unpaid dividends[6];
- c. Then, return of equity to members.

¹ CA unreported 19 July 2016

[1] *Michael Pearson (additional liquidator of Herald Fund SPC) (in official liquidation) v Primeo Fund (in official liquidation)* [2017] UKPC 19 at [1].

[2] This view was supported by the provision in the articles in question that redemption occurred on the surrender of the status of shareholder, rather than on payment; see Privy Council judgment at [14].

[3] Privy Council judgment at [18].

[4] Privy Council judgment at [35].

[5] Companies Law, section 49(g)

[6] See *Centaur Litigation SPC & Ors*, Unreported, Mangatal J 28 November 2017.

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