

Courts Again Uphold Certainty for Investors in Cayman Islands Funds

The Privy Council has confirmed in *Pearson (in his capacity as Additional Liquidator of Herald Fund SPC (in Official Liquidation)) v Primeo Fund (in Official Liquidation)* that NAV calculated in accordance with the company's constitutional documents will, absent internal fraud¹, be binding. In doing so the Privy Council held that the power under Cayman Islands law permitting an official liquidator of a solvent company to "*settle and, if necessary rectify the register of members, thereby adjusting the rights of members among themselves*" does not allow a liquidator to rectify the register in a manner which does not reflect the members' legal rights.

Therefore, absent internal fraud, a fund's Net Asset Value ("NAV") that has been calculated in accordance with the company's constitutional documents remains legally binding. This is the case even if, with the benefit of hindsight, an external fraud committed against the fund by a third party means that the struck NAV did not reflect the fund's underlying assets. This was the circumstances with Herald, the external fraud being Bernard Madoff Investment Securities LLC ("BLMIS") on Herald.

This is good news for investor certainty and reflects an important and continuing trend from the Cayman Islands courts of upholding the bargained for legal rights of investors. The decision also provides useful clarification on the scope of

liquidator's powers and the circumstances in which they can be exercised.

Background

A Cayman Islands investment fund, Herald suffered significant loss through the Madoff fraud. Prior to being wound up, Herald acted as a feeder fund to BLMIS into which Herald invested substantially all of its assets. Primeo, another Cayman Islands fund, was a substantial investor in Herald. Upon the discovery of the Madoff fraud, Herald suspended the publication of its NAV, and the issue and redemption of its shares. As at the date of the suspension, some of Herald's investors had redeemed their investments in full, receiving both a return of capital and also the fictitious profits represented by the NAVs, which are now known to have been incorrect as a result of the Madoff fraud. Certain other investors, including Primeo, had redeemed their investments in part, but remained members of Herald in respect of the balance. Both Herald and Primeo went into liquidation in the Cayman Islands.

Under the relevant Cayman Islands legislation, a liquidator of a solvent fund (i.e. a fund that can pay its creditors, even though there would be a shortfall on returns to investors), must exercise their power to rectify the company's register of members where the NAV is "*not binding upon the company and its members by reason of fraud or default*".

¹Fraud committed inside the company, for example by a director.

Additionally, where it is impractical or not cost effective to rectify the company's register of members in accordance with the true NAV, liquidators are required to *"rectify the register in such a manner which is both cost effective and fair and equitable as between the shareholders"*. These provisions had not, prior to the Herald litigation, been the subject of judicial scrutiny.

In an effort to even out the impact of the Madoff fraud on investors who remained members at the commencement of liquidation, Herald's liquidator made a proposal for the distribution of Herald's surplus assets on a 'net investment' basis. This would have resulted in members receiving significantly different returns than if distributions were made in accordance with the shareholdings recorded in Herald's register of members at the commencement of the liquidation. The liquidator's position was that, where there had been external fraud on a solvent fund the statutory framework provided a broad discretionary power allowing a departure from the members' legal rights as set out in the constitutional documents.

Decision of the Privy Council

The Privy Council disagreed with the liquidator – upholding the decision of the Cayman Islands Court of Appeal. Fundamentally, the Privy Council's decision was based on the fact that the liquidator's interpretation of the relevant legislation would result in a *"significant and unprecedented change in the law"*, empowering liquidators to *"impose a scheme of fair distribution of their own devising in substitution for the members' legal rights"*. This was not the legislature's intention, and if it had been, much clearer wording in relevant legislation would be required. Further, such a new power would run contrary to the well-established pari passu principle, under which the assets of a company are to be applied equally among the

classes of stakeholders in accordance with their legal rights as at the commencement of the liquidation.

What does this mean for investors and liquidators of solvent funds and what is left for the courts to grapple with?

Determining NAV: Absent Internal Fraud the Articles of Association Remain Key

The starting point will always be to determine whether NAV has been calculated in accordance with the articles (the question did not arise in Herald as all parties agreed NAV had been so calculated). Where NAV has not been calculated in accordance with the articles, NAV will not be legally binding; meaning that it should be revisited and calculated in accordance with the legal rights of investors (those agreed to in the articles). "True net asset value" is NAV calculated in accordance with the articles, and will therefore be subject to any express wording as to when NAV is to be considered binding and for what purposes.

However, where there is 'internal fraud' even if NAV has been calculated in accordance with the articles, the NAV will not be binding. In these circumstances the liquidator will either have to carry out what could be a painstaking process of reconstructing the NAVs in order to determine what those rights are, or if that is impracticable, have to apply a fair and equitable proxy for those rights and then in either case rectify the register of members accordingly. Whether a liquidator (or another party) will need to apply to the court to approve the reconstructed NAV or alternate fair and equitable proxy for members' legal rights is not clear.

What constitutes internal fraud?

Herald did not involve an internal fraud (the fraud was external; BLMIS on *Herald*). Therefore, the Privy Council did not need to consider the dividing line between external and internal fraud – which may not always be clear cut. For example, at one end of the spectrum the Weaving² fraud was clearly internal (the fraud was committed by a de-facto director) at the other end of the spectrum in *Herald* the fraud was clearly external (committed by BLMIS (a separate legal entity) on *Herald*). However, what if the fraud is initially external to the fund but there are allegations that the fund's directors were complicit in, or turned a blind eye to, the fraud? The lines may not always be clear. While in the context of the large number of funds incorporated in the Cayman Islands cases of fraud (let alone clear internal fraud) are rare; the question of what amounts to internal as opposed to external fraud may be one that future liquidators need to grapple over.

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² Read our legal update on the Privy Council's decision in *Weaving*: [https://maples.com/Knowledge-Centre/Analysis-](https://maples.com/Knowledge-Centre/Analysis-and-Insights/2019/08/Weaving---Cayman-Islands-Clawbacks-and-Investor-Certainty)

[and-Insights/2019/08/Weaving---Cayman-Islands-Clawbacks-and-Investor-Certainty](https://maples.com/Knowledge-Centre/Analysis-and-Insights/2019/08/Weaving---Cayman-Islands-Clawbacks-and-Investor-Certainty)