Cayman Court dispenses with the Houldsworth rule

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Misled or defrauded shareholders may rank equally with creditors in liquidations of insolvent funds

In the recent decision of *Re HQP Corporation Limited* **[1]** the Grand Court of the Cayman Islands declined to follow the 19th century English House of Lords decision of *Houldsworth v City of Glasgow Bank* [2] and found that claims for misrepresentation were not only provable in the liquidation of a company but also rank equally with other unsecured claims. The decision has resolved long-running uncertainty around the status of claims of shareholders who are victims of misrepresentation or fraud, affording them equal status with ordinary creditors of a company in liquidation.

Facts

Re HQP Corporation involved two shareholders of a fund (the **Petitioners**) who presented a just and equitable petition against HQP Corporation (the **Company**) following disclosure of admitted fraud including misrepresentation of financial data and falsification of documents.

The Company was subsequently wound up, following which, the official liquidators made an application for directions from the Court in relation to, amongst other things, the admissibility and ranking of claims by the Petitioners for damages for misrepresentation in relation to their subscription for shares in the company (the **Misrepresentation Claims**).

The liquidators sought directions as to two questions in relation to the Misrepresentation Claims:

1. Whether the Misrepresentation Claims could be made, in principle, in light of the decision in *Houldsworth* (the ***Houldsworth* Question**); and
2. If the Misrepresentation Claims could be made in principle, how such claims would rank in

the liquidation of the company (the **Ranking Question**).

The rule in *Houldsworth*

In *Houldsworth*, the House of Lords found that a shareholder's *only* remedy against a company which had fraudulently induced the claimant to purchase securities in the company was rescission of the contract and *restitutio in integrum* (restitution) for the value of the shares. However, such remedies become unavailable as a result of the winding up of the company, meaning that the claimant's action cannot be maintained. The rationale for the rule in *Houldsworth* is, because the claimant remains a member when a company is in insolvent administration, they cannot also claim damages in relation to its shares.

The *Houldsworth* rule was widely criticised and was later abrogated in England by statute.[3] However, in the later House of Lords decision of *Soden v British and Commonwealth Holdings Plc,*[4] when dealing with a member seeking to prove in respect of a claim for misrepresentation, the Court found that such a claim was a claim by a member in their capacity *as a member* which is deemed to not be a debt of the company within the meaning of the UK Insolvency Act 1986. This meant that such claims ranked after those of unsecured creditors in the distribution waterfall and ahead of those of other shareholders.

The Australian High Court decision in *Sons of Gwalia*

The Petitioners in *Re HQP Corporation* argued that the *Houldsworth* rule had been rejected in other Commonwealth jurisdictions which follow English common law including Bermuda[5] and Australia. The Petitioners placed particular reliance on the Australian High Court case of *Sons of Gwalia v Margaretic*[6] in which the claimant filed a proof of debt in relation to a claim for damages and compensation under various Australian statutes and the tort of deceit in the liquidation of an insolvent gold mining company. In *Sons of Gwalia*, the Australian High Court found:

1. That *Houldsworth* was a decision peculiar to its time and should thus be read narrowly and could be distinguished from the present facts on the basis that it was dealing with an unlimited company where, upon liquidation, the investor was liable to pay calls as a contributory.[7] As such, what the investor in *Houldsworth* was trying to do was to, in effect, obtain reimbursement from the company in respect of its liability to pay calls in the winding up.[8] This set of facts was distinguishable from the facts in *Sons of Gwalia*.
2. On the true construction of the Australian Corporations Act 2001, the claims were not claims of the claimant in his capacity as a member as they were not founded on any obligations owed by or to him as a member. Instead, the claim arose out of the company's contravention of its obligations to him under statute and tort *separately* from its obligations to him as a member. Accordingly, the claims to recover losses due to the company's wrongdoing ranked equally with the claims of other unsecured creditors.[9]

The *Houldsworth* Question before the Grand Court

While Doyle J recognised that decisions of superior courts of England,[10] including the House of Lords and the Supreme Court, were persuasive and, in some cases, highly persuasive, he underlined that they are not binding on Judges in the Cayman Islands.[11] After a detailed analysis of the circumstances in which a Cayman Court could depart from a decision of a superior English Court, Doyle J found "*this is one of the rare cases where the court is justified, indeed obliged, to decline to follow the English decision*."[12]

Doyle J determined that the *Houldsworth* rule should be abandoned on the basis that:[13] (1) it is contrary to Cayman statute as claims for damages for misrepresentation clearly fall within the wide wording of section 139(1) of the Cayman Companies Act;[14] (2) the rule has been abandoned by the UK Parliament and heavily criticised in other jurisdictions; (3) its reasoning is inconsistent with contemporary company law; and (4) it was not persuasive on the present facts.

The Ranking Question before the Grand Court

The Petitioners' position was that the Misrepresentation Claims fell outside of section 49(g) of the Cayman Companies Act which provides:

(g) no sum due to any member of a company in that person's character of a member by way of dividends, profits or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between that person and any other creditor not being a member of the company; but any such sum may be taken into account for the purposes of the final adjustment of the rights of the contributions amongst themselves. (emphasis added)

Relying on *Sons of Gwalia*, Doyle J found that tortious claims for misrepresentation are not claims brought by a member in their capacity as a member and do not have as their foundation rights and obligations arising from their statutory relationship or the corporate constitution.[15] Accordingly, Doyle J found that the Misrepresentation Claims should rank as unsecured debts of the Company and *pari passu* with ordinary creditor claims.[16]

Conclusion

Re HQP Corporation implements an important change to the distribution methodology historically applied to Cayman funds. As a result of Doyle J's decision, unredeemed shareholders who can make out a misrepresentation claim rank equally to ordinary third party creditors and may also rank ahead of, not just other unredeemed members, but also redemption creditors.

In a contemporaneous hearing in the matter of *Re Direct Lending Feeder Fund Ltd*,[17] Segal J was faced with similar issues relating to the *Houldsworth* rule and the ranking of misrepresentation claims. As judgment in that matter is yet to be published, it remains to be

seen whether Segal J will follow Doyle J's approach in *Re HQP Corporation*.

For more information on the Houldsworth rule, please contact one of our team via their below details.

[1] (Unreported, Doyle J, 7 July 2023).

[2] (1880) 5 App Cas 317.

[3] Section 111A of the UK Companies Act 1985 (which was inserted by the Companies Act 1989) provides: "*A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares*". This is now retained in s 655 of the Companies Act 2006.

[4] [1998] AC 298.

[5] In the decision of *Televest Ltd* (12 July 1995), Ground J distinguished between the entity in *Houldsworth*, which was a banking co-partnership, with the entity on the facts finding: " *the shares were essentially an investment vehicle and not in any real sense to be compared with the type of shareholding envisaged by their Lordships in Houldsworth's case...I find that the circumstances before me are different and distinguishable*."

[6] (2007) 231 CLR 160.

[7] *Sons of Gwalia* at [20].

[8] *Sons of Gwalia* at [20].

[9] Following *Sons of Gwalia*, legislation was passed by the Australian Parliament (the *Corporations Amendment (Sons of Gwalia) Bill 2010*) reversing the effect of the decision as to the order of priority and confirming that unsecured creditor claims have priority over shareholder claims.

[10] Other than the Judicial Committee of the Privy Council hearing an appeal from the Cayman Islands: *de Lasala v de Lasala* [1980] AC 546.

[11] *Frankland v R* [1978-80] MLR 275; *Energy Investments Global Limited v Albion Energy Limited* [2020] JCA 258; *Ramoon v Governor of the Cayman Islands* [2023] UKPC 9.

[12] *Re HQP Corporation* at [166].

[13] *Re HQP Corporation* at [172].

[14] *Re HQP Corporation* at [169]. Section 139(1) provides: "*All debts payable on a contingency*

and all claims against the company whether present or future, certain or contingent, ascertained or sounding only in damages, shall be admissible to proof against the company and the official liquidator shall make a just estimate so far as is possible of the value of all such debts or claims as may be subject to any contingency or sound only in damages or which for some other reason do not bear a certain value."

[15] *Re HQP Corporation* at [199]-[200].

[16] *Re HQP Corporation* at [201].

[17] (FSD 108 of 2019).

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