

## Unresolved questions from Primeo case on funds, creditors and priority

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This article continues Ogier's discussion in relation to the latest Cayman Islands Court of Appeal decision in *Primeo* and outlines the issues facing investors in relation to the priority of payments in Cayman Islands funds.

#### Recap

Primeo, an investor in a Bernie Madoff feeder fund called Herald, redeemed out of Herald in December 2008. Primeo's redemption request was accepted but, before the redemption proceeds were paid to Primeo, Bernie Madoff confessed his fraud and the directors of Herald suspended payments of redemptions. Herald later went into liquidation.

There is a statutorily imposed order of priority of payments whenever a Cayman Islands fund is put into liquidation and, in order to be paid ahead of other investors in Herald, Primeo argued that they should rank alongside unsecured outside creditors of the fund.

The Court of Appeal held that an investor that has had its redemption request accepted but has not been paid has a standalone claim against the fund. This is a claim outside of section 37 (7) of the Companies Law which provides that where a company is being wound up, the terms of any redemption rights may be enforced against a company in relation to shares which are or are liable to be redeemed and have not been redeemed by the company.

However, despite whilst finding that Primeo had an enforceable debt against Herald, the Court of Appeal also found that the debt arose out of Primeo's relationship with the Fund, and was therefore due to it in its character as a member, and was therefore subordinated to outside creditors, by operation of section 49 (g) of the Companies Law, which provides '*no sum due to any*

*member of a company in his 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 himself 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.'*

## The problems

There are two fundamental problems arising from the Grand Court and Court of Appeal decisions. First, it is unclear to whom section 37 (7) of the Companies Law actually applies. Secondly, the Court of Appeal's findings result in an anomaly whereby a creditor whose claim arises under s37(7) will rank equally with those redeemed members who are creditors in their character as members (by operation of 37(7)(b)(i)), but somehow at the same time rank behind existing shareholders with preferred rights (section 37 (7) (b) (ii) of the Companies Law).

## Who does section 37 (7) apply to?

Having found that an investor whose redemption request had been accepted had an enforceable debt against the company, the Court of Appeal had to explain in what circumstances section 37 (7) would actually operate.

The Court of Appeal found that it would operate in circumstances where a shareholder has accrued an enforceable right of redemption (i.e. where a redemption notice had been accepted) but that redemption had not been completed because a further step, such as a NAV calculation, was required. The Court of Appeal also held that it was conceivable that there could be articles of association that granted an investor an enforceable right but required "some further steps to be taken before redemption occurs".

However, the difficulty with this reasoning is that the Court of Appeal's decision creates envisages a scenario where fund's articles provide that having accepted the redemption request, something else is required in order to effect the redemption. But the analysis in that scenario would suggest that if something else is required under the articles before redemption takes place, the redemption right has not crystallised, and the member would continue in their status as an unredeemed member, ranking with all other members. The specific example given by the Court of Appeal is that the fund's articles required the NAV to be calculated as a further step, before redemption takes place, but this is not a term that is ever seen in Cayman fund articles. Therefore it appears that 37(7)(a) has been left largely redundant following this decision.

The Privy Council's decision in *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited* makes clear that the redemption process is concluded in accordance with a fund's articles of association and offering documents. Put simply, the fund either accepts a redemption request (and the investor becomes a debtor) or the fund rejects the redemption request.

## What about section 37 (7) (b) (ii)?

If, notwithstanding the analysis above, someone were to find themselves falling within the limited circumstances in which 37(7)(a) applies, it would then become wholly unclear how that person would rank viz a vis the other creditors and shareholders of the fund.

Section 37 (7) (b) provides that:-

*'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...'*

This leads to the rather perverse outcome that someone who has an accrued enforceable right under 37(7)(a) ranks alongside others who have redeemed and are creditors in their character as a member and yet rank behind preferred shareholders. If this is correct this would create a wholly new and clearly unintended order of priority - with preferred shareholders ranking ahead of those who have a creditor right in their character of members. This point was not considered by the Court of Appeal and does not appear to have been argued. Even if one considered 37(7) redeemers not as creditors at all but as members, this does not assist with the anomaly as (i) both the Jones J first instance decision and the Court of Appeal judgments both refer to those who fall under s.37(7) as "creditors" or as those with accrued rights and (ii) s37(7)(i) expressly ranks these redeemers alongside others who have a debt due to them in their character as a member.

It therefore will fall to the Privy Council or to the Courts in a future case to clarify the position of whether anyone could come within 37(7) and if so, where they rank.

## Where to now?

Section 37 was a direct import from English legislation and it is only when section 37 has been tested by the application of facts based on offshore funds that the unsuitability of the section has become apparent.

The Court of Appeal's decision is being appealed to the Privy Council and whether the Privy Council can give further guidance (or clarification) on a complex and largely unanalysed area of Cayman Islands law remains to be seen.

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