IN THE COURT OF APPEAL OF THE CAYMAN ISLANDS

C.I.C.A. (Civil) 5/2017
(FSD 27 OF 2013 – AJJ)

IN THE MATTER OF THE COMPANIES LAW (2013 REVISION)
AND IN THE MATTER OF HERALD FUND SPC (IN OFFICIAL LIQUIDATION)

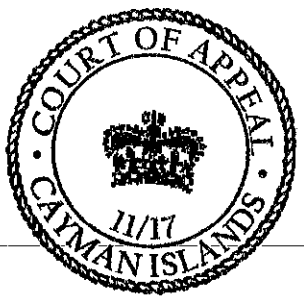
BETWEEN

PRIMEO FUND (IN OFFICIAL LIQUIDATION)

Appellant

AND

MICHAEL PEARSON
IN HIS CAPACITY AS ADDITIONAL LIQUIDATOR
OF HERALD FUND SPC (IN OFFICIAL LIQUIDATION)



Respondent

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PRIMEO FUND (IN OFFICIAL LIQUIDATION)

Respondent

BEFORE: The Rt. Hon Sir John Goldring, President
The Hon John Martin QC, Justice of Appeal
The Hon Sir George Newman, Justice of Appeal

Appearances:	The Rt. Hon Lord Peter Goldsmith QC and Mr. Francis Tregear QC instructed by Mr. Mathew Goucke and Mr. Christopher Keefe of Walkers for the Respondent/ Appellant, Michael Pearson. Mr. Tom Smith QC instructed by Mr. Peter Hayden, Mr. Rocco Cecere and Mr. Christopher Levers of Mourant Ozannes for the Appellant/Respondent, Primeo Fund (in Official Liquidation)
Hearing:	7 and 8 September 2017
Judgment delivered (for comments):	9 January 2018
Judgment finalised and approved:	27 February 2018

JUDGMENT

Newman JA.

1. There are two appeals before the court from rulings dated 12 June 2015 and 2 September 2016 delivered in the Financial Services Division of the Grand Court by the Honourable Justice Andrew Jones QC. They have been consolidated for hearing in this court. The appellants, Primeo Fund (in Official Liquidation) ("**Primeo**") and Herald Fund SPC (in Official Liquidation) ("**Herald**") were constituted in the Cayman Islands as exempt companies, respectively, on the 18 November 1993 and on 24 March 2004. They operated as open-ended investment companies and invested virtually their total investment assets in Bernard L. Madoff Investment Securities LLC ("**BLMIS**").

2. On 11 December 2008 Bernard Madoff confessed that he had been operating a massive "*Ponzi*" scheme and that BLMIS had never acquired any assets and securities. Totally fraudulent valuations had been placed on non-existent securities and where redemptions had been made they had been made from the funds of co-investors. The financial fraud had affected investment funds handling massive sums by way of investment on behalf of individual investors including the appellants. It has given rise to claims and litigation in various jurisdictions in which liquidators have been seeking to recover assets for distribution to investors.

3. Open-ended investment companies have been popular and important vehicles in the provision of financial services in the Cayman Islands and a fraud on this scale affecting several companies could be seen as giving rise to far reaching consequences for the orderly administration of company liquidations. Principally it must have been obvious that there would be complex and novel problems for liquidators to resolve in connection with the distribution of surplus assets. Legislative action was taken. Amendments were introduced to the Companies Law (2013 Revision) and the Companies Winding Up Rules 2008 ("**CWR**") which came into effect in 2010, in what can be seen as an endeavour to provide a new course of action which liquidators could adopt when distributing the surplus assets of funds which had issued redeemable shares. It is clear that the legislature intended to effect a notable change in the law but the meaning and extent of the change introduced by the terms of section 112(2) has given rise to the controversy this court must resolve.

4. Both of the appellants are now in liquidation. The losses have been massive and the consequences for individual investors have been catastrophic. It has been acknowledged that those who make investments do so on terms governed by the general law and a contract and are normally aware of the risks attached to making investments. However it has been said that the scale of the Madoff fraud and the comprehensively fraudulent methods employed for its implementation are outside what any investor would contemplate could occur and are sufficient to require the intervention of the court where the legislature has endeavoured to point to a solution. It is correct that the scale and impact of a misfortune will generally heighten the appetite of a court to mitigate harsh consequences but equally to break the mould of the law runs counter to the highly valued principle of legal certainty. Herald's corporate and management structure followed a form commonly employed in the setting up of hedge funds. The fund was established and promoted by Medici Bank AG (now known as 20:20 Medici AG), as a fund for investment in BLMIS. Whilst historically Herald had, for a limited time, two segregated portfolios, at all material times, Herald had one segregated portfolio, Herald USA Segregated Portfolio One. It published an offering memorandum pursuant to which it offered both US$ and Euro denominated shares at an initial offer price of US$ 1,000 and Euro 1000 respectively. The initial offer period closed on 1 April 2004. Thereafter, shares were issued and redeemed on each Subscription/ Redemption day at the net asset value ("**NAV**") determined in respect of each share class as at the applicable valuation

point. By Article 18(f) of Herald's Articles "*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 providing 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.*" The directors' historical calculations of the NAV (performed via delegation to Herald's administrator, HSBC Securities Services (Luxembourg) SA ("**HSSL**")) are at the heart of this dispute.

5. Although the fraud had financially catastrophic consequences for the funds not all the assets of Primeo and Herald were lost. The ongoing liquidations are solvent and, once a scheme for their distribution has been settled upon, there will be substantial assets for distribution. But the scale, longevity and the manner in which the BLMIS fraud has been implemented have given rise to the deployment of considerable legal ingenuity in connection with the interpretation of a short legislative provision.

6. An essential feature of the operation of a Ponzi scheme is that investors' funds are used to pay out investors as they leave the scheme and take, what they believe to be, their legitimate profit. This gives rise to the happenstance that investors who redeem before the scheme collapses profit at the expense of their co-investors. Some aggravating features of the way in which the BLMIS fraud was perpetrated include the fact that there were no investments at all, the attribution of fictitious profits to investments and the inflation of valuations to further the reputation of BLMIS as a fund generating very high returns for its investors. Its false reputation encouraged new investment and encouraged investors who had redeemed to re-invest.

7. It has been submitted that these facts cry out for a solution which will mitigate the arbitrary and unfair consequences which have befallen innocent investors. It has been said that, so far as possible, parity between investors should be achieved, not only as a matter of fairness to them but also in order to avoid the offence to justice which will occur from sanction being given to the enjoyment of profits of fraud and an appearance being given that the court has implemented the outcome of the fraud. These are powerful and challenging considerations which have some measure of factual support. They have troubled me and they obviously troubled Justice Jones QC. That said the legal field for

their deployment is not clear of difficulty. This court has been taken to case law, including high authority in connection with the Madoff fraud, where closely related questions have been decided but in none of the cases has a statutory provision in the terms of section 112(2) been under consideration. The court has been asked to recognise the degree to which a lack of parity will create injustice for Herald's investors and to approach a solution by giving full effect to the concept that fraud can unravel all. The judge was understandably impressed by these arguments and he discerned in the broad terms of section 112(2) that there was an opportunity to achieve a measure of parity between investors. Primeo submits he went too far. Herald submits he was too cautious.

8. I can take the factual circumstances from the ruling of the US Court of Appeal for the Second Circuit in *In re Bernard L. Madoff Investment Securities* LLC 654F. 3d 229 (2 Cir.2011) "*Madoff used the investments of new and existing customers to fund withdrawals of principal and supposed profit made by other customers. Madoff did not actually execute trades with investors' funds so these funds were never exposed to the uncertainties or fluctuations of the securities market. Fictional customer statements were generated based on after-the-fact stock trades using already published trading data to pick advantageous historical prices....*" Fictitious paper account statements were regularly issued, deliberately engineered so that customers always appeared to be earning positive annual returns. These "*dreamt up rates of return were assigned to different customers' accounts...*", thus leading to significant and arbitrary variations between accounts. It follows that the inescapable consequence was that Herald's calculation of the NAVs was totally false and involved the distribution of so called profits which were the product of fraud. Article 18(f) placed the obligation to calculate the NAVs on the directors (which function was delegated by the directors to HSSL). There has been no dispute that HSSL fulfilled that obligation but it calculated and issued the NAV of Herald's shares on a totally false set of figures and fictitious investment transactions. Over the years in which Herald placed its assets with BLMIS they calculated innumerable false valuations. Unsurprisingly, it has not been suggested that a true NAV for each and every transaction could now be ascertained.

9. Yet further another circumstance occurred in the investment history and in Herald's relationship with Primeo, which has given rise to an acute conflict. From May 2004 Primeo began to subscribe for shares in Herald as well as continuing to place funds for

investment in BLMIS directly and through another fund. As at the 30 April 2007 Valuation Point its managed account with BLMIS purportedly showed a credit of US$463,353,186.26. On 2 May 2007 Primeo's rights in the managed account were assigned to Herald in consideration for the issue of 371,604.1272 USD class shares. After adjustments the final value of this "*in specie*" subscription by Primeo was placed at US$465,418,349.08 in consideration for the issue of 373,260.3648 USD class shares. All the calculations for this transaction were made on fraudulent and fictitious figures generated by BLMIS.

10. Herald filed a customer claim in the United States Bankruptcy Court in a sum calculated as the market value of the securities listed in its last statement of account issued by BLMIS. This included the final recorded value of the Primeo *in specie* subscription. The Trustee of BLMIS calculated Herald's customer claim on the basis that a customer could not recover in respect of the fictitious profits appearing in its last statement of account. In doing so he was applying a methodology known as the 'Net Equity Method' or the 'Net Investment Method'. It resulted in the valuation of US$149,780,967 as the amount which Primeo had invested in Herald when it assigned its holding to Herald. Herald agreed its claims with the Trustee and Primeo and its claim in the bankruptcy was allowed in the amount of US$1,639,869,943, which included the amount of US$149,780,967 in respect of Primeo's net invested principal in BLMIS. The difference between the recorded value of the *in specie* subscription at US$465,824,061 and the agreed amount is US$316,043,094, being fictitious profit reported by BLMIS.

The Proceedings between Primeo and Herald

11. The respective directors of Primeo and Herald passed resolutions on 12 December 2008 suspending redemptions and subscriptions. A resolution putting Primeo into voluntary liquidation was passed on 23 January 2009 and on the 8 April 2009 an order was made that the liquidation continue under the supervision of the court.

12. Herald attempted to conduct a different approach but Primeo presented a contributory's winding-up petition on 14 February 2013. Joint official liquidators were appointed by an order made on the 23 July 2013 and at the same time Mr. Michael Pearson was appointed

as an additional liquidator. In that capacity he is a party to the present proceedings. His powers and functions are limited as follows:

> *"The Additional Liquidator's functions shall be limited to settling the list of contributories pursuant to section 112(1) of the Companies Law and determining related issues, including whether (Herald's) register of members should be restated pursuant to section 112(2) of the Companies Law and whether (Primeo's) shareholding in (Herald) should be adjusted on the ground that the consideration for the issue of its shares was the transfer to (Herald) of the portfolio of securities and /or cash held by Primeo in its account with BLMIS, the amount or value of which had been fraudulently overstated."*

13. Primeo filed a summons in the liquidation of Herald seeking determination of the following issues:

> *"(i) whether the net asset values determined pursuant to Herald's articles of association in respect of each separate class of Participating Non Voting Shares issued by Herald are not binding upon Herald by reason of "fraud or default" within the meaning of Order 12 r.2(1) of the CWR and:*
>
> *(ii) whether Order 12 r.2(1) of the CWR applies so as to require the Additional liquidator to rectify Herald's register of members."*

14. Herald filed a summons seeking orders, *inter alia*, that the Additional Liquidator be authorised to:

> (i) adjust Primeo's number of USD class shares in Herald issued in respect of Primeo's *in specie* subscription to reflect instead a subscription of US$149,753,024; and
>
> (ii) rectify Herald's register of members pursuant to section 112(2) of the Companies Law and Order 12, rule 2(5) of the CWR.

THE LEGAL FRAMEWORK

RECTIFICATION OF THE COMPANY REGISTER.

15. 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 the power to adjust the rights of contributories amongst themselves.*
>
> *112(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 the power to settle and, if necessary rectify the company's register of members, thereby adjusting the rights of members amongst themselves.*
>
> *112(3) A contributory who is dissatisfied with the liquidator's determination may appeal to the Court against such determination.*"

16. 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*". Part V includes section 112. The Committee exercised its power and issued amendments including Order12, rule 2 of the CWR 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 on 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 on 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 the 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 the 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."

17. Before amendment in 2009, section 112 of the Companies Law dealt with contributories and by section 116 provided that the court (not the liquidator) had a power to make calls, to order payment of the amounts called and "*to adjust the rights of the contributories amongst themselves*". The duty of a liquidator to identify those liable to contribute to the assets of the company and to identify the amounts they are liable to pay has followed a well established process, governed by statutory provisions and illuminated by case law and is known as, "*settling the list of contributories*". Section 112(1) and Order 12, rule1 of the CWR currently provide for the manner in which the liquidator should perform this duty but these amendments to the section and the CWR have not otherwise materially changed the law. On the contrary there are no precursors to section 112(2) and Order 12, rule 2 of the CWR. The change introduced by section 112(2) is clear so far as it limits its application to a solvent liquidation of a company which has issued redeemable shares at prices based upon its net asset value but it is not so clear about the circumstances when it may be permissible and, in addition, necessary to adjust the rights of members amongst themselves.

18. It has to be said that the language employed by the draftsman to introduce this unusual, if not unique, statutory power in the field of company law might have been less economic. Order 12, rule 2 of the CWR has also been the subject of argument but its terms are clear and, it comprises a welcome exercise of the conventional role of secondary legislation by giving "*effect*" to the principal section in the statute. It is clear that it stipulates for the circumstances in which effect can be given to the power conferred by section 112(2). The issue as to whether it instances the only circumstance in which the section can be employed is not before this court. The point for determination is whether the facts of this case fall within section 112(2) and/or Order 12, rule 2 of the CWR. The judge interpreted it as imposing a mandatory obligation to act in the circumstances set out in the Rule, contrasting it with the principal section which he interpreted as creating a broad free standing discretion to act in similar circumstances and for the same purpose.

THE JUDGE'S REASONING

19. Jones J concluded that the language of section 112(2), being unqualified, pointed against the only circumstance in which rectification under the sub-section was possible, being

within the circumstances contemplated by Order 12, rule 2. He interpreted the power as a free standing discretion to be exercised in "*order to do justice amongst those recorded as members as at the commencement of the liquidation.*" There can be no dispute with the proposition that the provision is intended to serve the ends of justice. The critical argument has been over the circumstances in which the legislature saw it as necessary for the ends of justice to be determined by the liquidator. The judge's conclusion was that the BLMIS fraud had given rise to a circumstance affecting the contributories of Herald, which clearly fell within the legislative intent of the section and would therefore achieve justice.

20. In my judgment it would have been preferable for the judge to have determined the legislative intent on the same occasion as he determined the methodology whereby the statutory purpose could be achieved. By adopting the course of separate hearings the judge ran the risk of concentrating on the circumstances of the BLMIS fraud, allowing the "*injustice*" to carry undue weight and unduly influencing his conclusion on the interpretation of the section. This court had the benefit of hearing all the argument at the same hearing. The one illuminated the other. Unfortunately, as I shall point out, the judge's reasoning in the two Rulings on the same central issue was inconsistent. He did attempt at the second hearing to prevent argument on the conclusion he had already reached ruling it would not be right to re-open it, because the earlier decision had already been reported. But it has to be said his efforts failed. Relevant argument could not be avoided. At the conclusion of his first Ruling the judge stated as follows:

> "*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 transaction had been done at a true NAV. This is done with the benefit of hindsight in accordance with whatever 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*"

21. The judge's conclusion that section 112(2) created a broad discretion enabling the liquidator to rectify the register has to be seen in the context of his conclusion that Rule 2 was not in play because the NAVs were, notwithstanding the fraud, contractually binding. He rejected the argument advanced on behalf of the Additional Liquidator that if it was determined that the NAVs had been mis-stated by reason of fraud or default it was not necessary to go on and consider whether the NAVs were contractually binding or not. Drawing upon the judgment of the Privy Council in *Fairfield Sentry Ltd v Migani* (2014) UKPC 9 he concluded that on a true construction of Herald's articles the determination of the directors, acting in good faith, was intended to be definitive (See Article 18(f)). Having cited a passage from the judgment of Lord Sumption, who delivered the judgment of the Board, Jones J concluded that by "*parity of reasoning, I think it is highly improbable that Rule 2 was intended to operate in a 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.*" However, he did not extend the "*parity*" of the reasoning in *Fairfield* to the task of interpreting section 112(2). In paragraph 49 he stated as follows: "*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 the power is matter for determination at the next hearing".

22. It is clear that the Board of the Privy Council took a strong view against a suggested construction of the law (describing it as "*an impossible construction*"), which permitted uncertainty in connection with a determination of the NAV of a company which had issued redeemable shares. The possibility of the determination of a NAV made by the directors being open to variation by the substitution of a different NAV based on information "*acquired long afterwards about the existence or value of the assets*" was roundly rejected. Having followed the reasoning in reaching his conclusion on the true meaning and effect of Rule 2 Jones J nevertheless concluded that his conclusion on the true meaning and effect of section 112(2) was not "*inconsistent with the policy considerations expressed by Lord Sumption in Fairfield Sentry*". It is not clear to me what "*policy considerations*" the judge had in mind.

23. The Additional Liquidator advanced an alternative argument for the intervention of the liquidator based on what was submitted to be the true meaning and effect of Rule 2. It was faintly suggested, as it was in this court, that the fraud or default contemplated by the rule did not have to be internal to the company. Further it was submitted that the mis-stated NAVs were not binding on Herald and its members for two reasons. First, it was said that there was a chain of delegation through the administrator and the custodian (BLMIS) which made the administrator acting on behalf of Herald liable for the fraud. Thus it was an internal fraud. Second, that there was manifest error on the face of the valuations and, as a result, they were not binding. Jones J held that even if there was a chain which led back to the fault of the administrator, Article 18(f) of Herald's articles meant that, unless the directors had acted in bad faith, their determinations were binding. In summary the judge held that there was a power by way of discretion for the liquidator, pursuant to section 112(2) to rectify the register but that there was no power or duty for him to act pursuant to Rule 2 because the NAVs were contractually binding.

24. The Additional Liquidator has appealed the judge's ruling on Rule 2 and Primeo have appealed the judge's ruling on section 112 (2).

THE SECOND RULING

25. Nearly a year passed before the judge had to revisit the findings he had made and determine the matters which had been left over for a second hearing. The argument on methodology generated voluminous affidavit material. In addition to the methodology issue the judge also considered whether it was a case in which, given that the power existed, the liquidator should exercise his discretion. He also decided and ruled on the discrete question to which the Primeo *in specie* subscription had given rise. It should be noted that at another hearing (other than those under consideration) held in February 2016 Jones J rejected the argument that the *in specie* subscription was void for mistake and he upheld the validity of the subscription agreement. That ruling has not been appealed by Herald. He held that the power in section 112(2) did not extend to rectify the register as against Primeo on the ground that the parties were mistaken about the value of the consideration given by Primeo in the *in specie* subscription.

THE DISCRETION ISSUE

26. The judge was invited to re-open this issue, there being no final order, and because it was submitted he had erred. He declined but concluded that it was necessary to consider the purpose and effect of the legislation in order to decide whether or not the discretion should be exercised. He heard argument and he accepted the submission of Leading Counsel for Primeo that the power to rectify the company's register of members is only exercisable where the applicant has an existing legal right to be registered or, conversely, where the company has an existing legal right to have the shareholder's name removed from the register (see section 46 of the Companies Law (2013 Revision), section 35 *Companies Act* (England) 1862 and *Nilon Ltd v Royal Westminster Investments SA* (2015) 2 BCLC 1).

27. It seems to me that it was inevitable that in considering whether the liquidator should exercise his discretion the meaning of the section would have to be revisited. Leading Counsel for Primeo introduced arguments which it seems likely he would have advanced had the earlier Ruling been re-opened. The judge reviewed the impact of the submissions in his second ruling. He pointed to the original *Companies Law*, Cap 22, which had reproduced all the elaborate provisions in section 98 to 106 of the English 1862 Act which dealt with settling the list of contributories and making calls against them. He

noted that the provisions of section 38 of the 1862 Act (dealing with the liability of members to contribute to a company's assets) are reproduced in section 49 of the Companies Law (2013 Revision). His brief review of the legislative history was completed by reference to the regime introduced by the Companies (Amendment) Law 2007 and the Companies Winding Up Rules 2008. They had resulted in sections 112(1) and 113 appearing in more simplified terms than the elaborate provisions which followed the 1862 Act. Leading Counsel drew attention to all these aspects of legislative history in order to set the relevant legal context for the interpretation of section 112(2).

28. The submissions were accepted. They led the judge to observe that sections 112(1) and 113 have "*their genesis in the 1862 Act because they continue to deal with settling the list of contributories and making calls against contributories*". He was persuaded that it could not have been the intention of the legislature to confer power on a liquidator to interfere with the "*proprietary rights of shareholders*". He recognised that the power to rectify the register in section 112(2) did not extend to a former shareholder who had validly redeemed his shares nor did it extend to rectify so as to give effect to a scheme of distribution different from that mandated by section 140(1) of the Companies Law. Leading Counsel for Primeo accepted that section 112(2) as amended and Order 12, rule 2 of the CWR were entirely new provisions, that they were expressly aimed at dealing with cases where the NAV had been materially mis-stated, including cases where the mis-statement had occurred as a result of fraud or default, but the thrust of his submission and his aim was to persuade the judge that the broad terms of section 112(2) had to be interpreted in the context of a statutory framework which had not radically changed. The judge agreed that,"(T)*he power is expressed in very general terms but, because its exercise is dependent upon the company having issued redeemable shares at prices based upon its NAV, it seems ...that the legislature must have intended that this power of rectification will be exercisable only in circumstances where the NAV has been materially mis-stated. This is the way in which it has been interpreted by the Insolvency Rules Committee.*" The ratio of the first ruling was that "*contractual rights*" could be overridden in order to achieve "*substantial justice*" by eliminating the effect of the BLMIS fraud. A concept of materiality had not been expressed.

29. The submissions at the second hearing elicited reasoning which was not expressed in the first Ruling. In paragraph 23 of the second Ruling the judge stated: "*The concept of*

"rectification" under section 112(2) implies restoring the register to the position which accurately reflects the relative position of the shareholders as it would be if all the relevant subscriptions and redemptions had been transacted at a true NAV". Further the judge observed: "*The language of section 112(2), especially when read with CWR Order 12, rule 2 which was brought into force simultaneously with the statute, does not permit any wider interpretation*". By concentrating on the statutory purpose as being the substitution of a true NAV and the assumption that this was the justice the legislature intended should be achieved, the judge adopted an approach consistent with his previous Ruling. However in the same paragraph of the second Ruling almost immediately thereafter he stated: *"I agree that it is inherently improbable that the legislature intended to confer upon the official liquidator a power to interfere with an individual shareholder's proprietary rights in the company"*. As I understand the judge's conclusion the substitution of a "*true*" NAV necessarily meant that the NAV calculated by the directors, pursuant to the contract with its members, would be erased from the register. I am unable to see how this does not override the proprietary interests of the shareholders.

30. The judge recognised the need for section 112(2) to be given a narrower interpretation than its terms suggested. He recognised the importance to be attached to the proprietary rights of shareholders, as well as the impact of the processes established by the Companies Law and the cases for rectifying the register, but he concluded that the power to rectify the register conferred by section 112(2) was "*in the nature of a class remedy, the purpose of which is to restore the register of members to a position which reflects the result of substituting true NAVs for those which had been mis-stated.*"

THE METHODOLOGY TO BE ADOPTED

31. The Additional Liquidator provided detailed evidence which suggested a choice between two methods which would give rise to shareholders sharing equally in the pool of funds available for distribution, namely the Net Investment Method and the Rising Tide Method. The Additional Liquidator expressed a preference for the latter. The judge rejected both methods and formulated his own to which I shall come later. In this court the Additional Liquidator abandoned the Rising Tide Method and argued for the Net Investment Method.

32. The judge's reasoning can be summarised as follows:

(i) Herald's shareholders have suffered a common misfortune as victims of the Madoff fraud. To recover an equal proportion of their net cash invested would be just.

(ii) Section 112(2) and CWR Order 12, rule 2 provide a mechanism for achieving a just result by "...allowing members' shareholdings to be adjusted on the basis of NAVs which are deemed to be true or at least not distorted by the inclusion of fictitious profits".

(iii) The solutions put forward by the Additional Liquidator are legally inadmissible because they conflict with the scheme of distribution set out in section 140(1) of the Companies Law (2013 Revision).

(iv) "*Substituting true NAVs for mis-stated ones does not circumvent section 140(1) because the assets will be distributed in accordance with the shareholders' rights and interests in the company as reflected in the rectified register.*"

(v) "*Section 112(2) permits the register to be rectified in order to give effect to the substitution of "true NAVs" for those which were mis-stated ...notwithstanding that the mis-stated NAVs would otherwise be binding as a matter of contract.*"

THE IN SPECIE SUBSCRIPTION BY PRIMEO

33. The judge concluded that there was no basis upon which the Additional Liquidator could interfere with the contract between Primeo and Herald which was "*binding and enforceable in accordance with its terms... The Additional Liquidator's power is limited to re-stating the number of shares which ought to have been issued in consideration for US$465,824,061 at a 'true' NAV.*"

THE ISSUES FOR DETERMINATION IN THIS COURT

Section 112(2)

34. The facts which must exist in order to give rise to the jurisdiction of the liquidator to act are clearly set out in the section. Where a company has issued redeemable shares at

prices based upon its NAV and the company is in solvent liquidation, the liquidator has a power to settle the register of members and if necessary to rectify the register by re-stating the number of shares to which a member is entitled at the commencement of the liquidation. The circumstances in which rectification of the register may be necessary are not stated nor does the section specify the process the liquidator should adopt to determine the number of shares to which a member should be treated as entitled.

35. Primeo's submission that a share is "*property*" conferring on its holder rights in and against the relevant company including, on a liquidation, the right to receive funds from the distribution of the surplus assets in accordance with the number of shares held at the commencement of the liquidation has, correctly, not been challenged. Further section 46 of the Companies Law allows the register to be rectified so as to ensure that only those who are entitled, as a matter of law, to be listed are on the register. Thus rectification takes place so as to give effect to the existing rights of members (see *Nilon Ltd v Royal Westminster Investments SA* (2015) 2 BCLC. 1).

36. It is necessary to ask when considering the effect of section 112(2) whether the intention was to confer a power to grant and remove rights and create new rights, as opposed to introducing a new circumstance for giving effect to existing rights by a process of rectification which, if not effected, would mean that the true legal position was not entered on the register. It seems to me that the nature and extent of the power depends upon the meaning to be given to the word "*rectify*". Since the section applies, only where there is a solvent liquidation and the power to rectify applies to the register of members, it can be taken to be contemplating a net asset value which has been calculated and for some reason can be seen by the liquidator to show a member as having more or less shares than the member's legal entitlement. But the words of the section set no limit on the range of circumstances which could give rise to a relevant incorrect NAV. The section makes no mention, for example, of fraud, even though it is obvious that fraud is capable of giving rise to an incorrect NAV. Further, if it is only by reference to facts which have become known since HSSL calculated it, that it can be seen to be incorrect, the question arises as to whether the section has introduced a general power to calculate and then substitute a correct NAV even though it has been calculated by the directors and is binding according to Article 18(f). HSSL's calculation, if made in good faith and in the best interests of the company as a whole, is not open to challenge, and will be binding in

accordance with the contract. It will give rise to an entitlement to shares according to the nominal number of shares held at the date of the commencement of the liquidation. If HSSL's calculation is not binding the members' rights will be those available to the member and the company according to the general law. Since the introduction of section 112(2) those rights include the power of the liquidator to act under the section. I am satisfied that the intention could not have been to create a power to calculate a correct NAV and substitute it for the incorrect NAV which has, despite its incorrectness, been calculated in accordance with a member's contractual rights. As Primeo has submitted it could not have been the intention of the legislature to confer a discretionary power upon a liquidator to deprive a person of his or her accrued legal rights. The meaning and purpose of the section is to provide a mechanism for a calculation to be made where members' rights according to the general law require some determination to be made. The adjustment of rights of the members "*amongst themselves*" to which the section refers is an adjustment which achieves the purpose of correcting an incorrect NAV in accordance with the rights of the shareholders. In my judgment the liquidator has no wider power to act than is conferred by the word "*rectify*" which is to be understood and to take its meaning from the statutory context of the Companies Law in which it appears.

37. The judge did attempt to limit the power by reference to its context in the operation of the Companies Law and he identified where the power to rectify would be in conflict with statutory provisions. By this approach he accepted that it could not just mean that where something was incorrect the law permitted the liquidator to correct it. The common thread of the limitation, which can be recognised from the examples he gave, was that the existing rights of members had to be respected. It follows that he fell into error and reached the wrong conclusion in his first Ruling. In paragraph 49 of the first Ruling he concluded: "*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.*" He added: "*Whether or not the Additional Liquidator of Herald should exercise this power is a matter for determination at the next hearing*".

38. However at the next hearing, despite ruling he would not re-open the issue, he heard extensive argument which caused him to conclude in paragraph 23 of the second Ruling that it "*was inherently improbable that the legislature intended to confer ...a power to*

interfere with an individual shareholder's proprietary rights in the company". He drew attention to the inability of the section to operate as against a shareholder who had redeemed his shares and the inability of the liquidator to give effect to a scheme of distribution contrary to section 140(1) of the Companies Law (2013 Revision). Whereas in his first ruling he formulated the purpose as being "*to achieve substantial justice amongst the shareholders*", in the second Ruling he concluded that: "*The power conferred by section 112(2) is in the nature of a class remedy, the purpose of which is to restore the register of members to a position which reflects the result of substituting true NAVs for those which have been mis-stated*". The concept of a "*true*" NAV was borrowed from Order 12, rule 2(2) and (3) of the amended CWR. Section 112(2) makes no mention of this concept.

39. The conclusion that it was "*improbable*" that the legislature intended to interfere with shareholders' proprietary rights was an entirely sound, reliable aid to the interpretation of the section. It reflects the dictum of Lord Devlin in *National Assistance Board v Wilkinson* (1952) 2QB 648 at 661:

> "*It is a well-established principle of construction that a statute is not to be taken as effecting a fundamental alteration in the general law unless it uses words that point unmistakably to that conclusion*".

It is clear that to deprive shareholders of a company of the benefits they have received pursuant to their rights under a valid and subsisting contract with the company amounts to a substantial interference with their legal rights. A "*power*" to adjust the rights of "*members*" is not "*unmistakably*" pointing to the creation of a power to take away accrued rights. Without the extended meaning given to the power, the section has a meaning and purpose to which effect was given in Rule 2. Read together the section and the Rule have created acceptable certainty. The interpretation of the power as a power to "*achieve substantial justice among shareholders*" is, so far as it goes, unimpeachable, but it provides no support for the contention that the legal rights of members can be overridden in the process. It begs the question whether by taking away accrued legal rights substantial justice is achieved or not. The exercise of any statutory power, properly granted, can be taken to be exercisable for the purpose of achieving justice. Justice for some shareholders may be seen to be based on contractual rights being upheld. A broader concept of justice may be seen as being maintained by upholding certainty in

the law. Having regard to *Fairfield Sentry*, in the context of company law, the principle has held considerable sway.

40. The judge's formulation of the purpose of the power in the second Ruling, at paragraph 24, as being in "*the nature of a class remedy*", might be seen as recognition on his part of the substantial difficulty presented by interfering with individual members' rights. In order to rectify the register it is necessary to identify the legal right of a member which should have been stated in the register and to substitute it for the incorrect calculation. The register can be rectified in order to declare the rights which have accrued to a member in accordance with his contract and the general law governing that contract. The purpose is not to "*restore*" the register of members to a position which reflects the substitution of true NAV or a nearly true NAV or a NAV which does not reflect fictitious profits or which achieves substantial justice. Whether a mis-stated NAV can be rectified depends upon what the contract between the shareholder and the company has stipulated should be binding between the parties and what measures have been authorised by statute to give effect to the rights of the members.

The CWR

41. The conclusion reached by the judge that the purpose and effect of Rule 2 was to provide for a set of circumstances in which the liquidator was bound to act and rectify the register in accordance with his determination of the true asset value as at each relevant redemption date or failing that being cost effective and practical, to be "*fair and equitable*", was plainly correct. But Rule 2 only contemplates this power being exercisable when the contract between the shareholder and the company is not binding "*by reason of fraud or default*". This prescribed method for implementation of section 112(2) is *intra vires* the power conferred because it does not override the contractual rights of the shareholders and the company. It reflects the interpretation of the section stated above. If the net asset value is not correct and is not binding on the company or the shareholders, the rule gives effect to the power in the principal statute to achieve justice for shareholders through a determination by the liquidator and, if necessary, the court in place of what could be a multiplicity of actions taken and determinations obtained by individual shareholders to enforce their legal rights arising out of the fraud or default. In this respect the judge was right to consider it as a form of class remedy.

42. The Additional Liquidator's argument that the Rule renders any NAV affected by fraud or default not binding is not sustainable. It is contrary to the plain meaning of the words and would produce results which could not have been intended by the rule making authority (see paragraph 32 of the first Ruling). Further, contrary to the submission to the effect that the case of *Skandinavisaka Enskilda Banken AB v Conway* CICA No.2 of 2016 supported the approach that, whenever there was fraud affecting the calculation of a NAV it should be regarded as inapplicable, the judgment of the court delivered by Martin JA, pointed to the need for certainty and finality in the determination of NAVs and the undesirability of NAVs used for the issue and redemption of shares being re-opened. In so doing the court followed the approach of the Privy Council in *Fairfield Sentry,* concluding that the NAVs had been calculated in accordance with the articles and were binding.

The Chain of Attribution

43. The Additional Liquidator submitted in the alternative that it could be shown that the contracts of subscription between Herald and its directors were not binding. In short the argument traced the role of Herald's administrator and custodian and its appointment of BLMIS as a sub-custodian which had provided the fraudulent information to the custodian. Thereby it was said the custodian/administrator became liable for the fraud under the terms of its agreement with Herald. In my judgment the judge was right to reject the submission because it ignored the binding terms of Article 18(f) which had not been shown to be inapplicable. Further, as was submitted by Primeo, it confused the roles of Custodian and Administrator performed by HSSLand ran contrary to the argument of the Additional Liquidator that he was not advancing a case of fraud against HSSL.

THE PRIMEO IN SPECIE SUBSCRIPTION

44. The arguments can be summarised as follows. It was submitted that the number of shares allotted to Primeo should be treated as void on the grounds that Primeo had provided insufficient consideration or that the transaction was void on the ground of mistake. The latter argument could not survive a separate ruling by Jones J in February 2016 who held that whilst the parties may have been mistaken about the value of Primeo's rights against BLMIS that was not a ground upon which the subscription could be held to be void for

mistake. The judgment was not appealed. As to the contention that the consideration could be shown to have been insufficient the judge correctly ruled that the transaction could not be impugned on this basis. In the light of my conclusion on the meaning of section 112(2) no route for challenging the *in specie* subscription lies under that section.

Miscellaneous Grounds

45. I do not propose to comment on an argument raised by the Notice of Appeal of the Additional liquidator where reliance was placed upon the combined effect of section 112(1) and section 46 of the Companies Law. It was not developed in the skeleton or oral argument. The judge heard argument on the issue of the currency in which the payments from proceeds could be made. He held that the holders of Euro class shares were entitled to receive payment in Euros. Since the terms of Article 155 of the Articles permit payment in whatever currency the liquidator may determine there would appear to be no live issue on this conclusion.

46. In the light of my conclusion on the meaning of the section it is unnecessary to consider whether the Rising Tide Method or the judge's solution can be adopted.

47. For the reasons given above I would:

1. Allow Primeo's appeal against the judge's ruling in connection with the meaning of section 112(2) and the effect of Order 12, rule 2 of CWR;
2. Dismiss the Additional Liquidator's appeal against the judge's ruling on the *in specie* subscription issue; and
3. Order the parties to serve written submissions in connection with costs within 14 days if no agreement can be reached between them.
4. The parties should agree an order answering the issues raised by their summonses in accordance with the above conclusions.

Goldring, P.

I agree.

Martin, JA

I agree also.