Chancery Bar Association - Cayman Islands Conference 2016

Clawback Claims in Cayman

INTRODUCTION

1. Elements of this joint paper were presented as part of a panel session on clawback claims at the Chancery Bar Association's Cayman conference on 12 May 2016.

2. The session also featured a paper by Peter McMaster QC discussing the possibility of adopting in Cayman the U.S. approach to Ponzi schemes which attempts to achieve an equitable distribution of loss among victims rather than throwing the whole loss on those who remain invested at the point of collapse.

3. This joint paper takes as its more prosaic focus the scope for obtaining clawback under the law as it currently stands in the Cayman Islands. In so doing it addresses:

3.1. Clawback claims based upon false declarations of net asset value (**"NAV"**); and

3.2. The avoidance of preferential transactions under s.145 of the Companies Law (2013 Revision) (the **"Companies Law"**)[1].

THE CONTEXT OF CLAWBACK

4. In both Cayman and other jurisdictions there have recently been a number of (largely unsuccessful) attempts to claw back monies from investors who have redeemed their shares in investment companies which have subsequently been found to have been used as vehicles for fraud.

5. Commonly such companies permit investors to apply in advance for the redemption of their shares at a price determined by reference to a NAV which is to be struck on a given date by the directors of the company in question or others acting on their behalf. Such declarations of NAV are often expressed to be binding on all parties concerned, albeit with express or implied caveats that such declarations are to be free of manifest error and/or reached in good faith.

---

[1] A further attempt at claw back based on the proposition that redemption payments had unlawfully been made out of capital contrary to s.37 of the Companies Law was advanced in *DD Growth.* The liquidator's appeal on this point will be going to the Privy Council. While this raises a number of significant points of interest, its relevance for present purposes has been largely nullified by virtue of legislative amendment which means that the particular issue of unlawful reduction of capital in question is unlikely to arise in future.

6. When the true financial position of such companies are revealed, there is usually no doubt that the determined NAV and concomitant redemption payments were manifestly false. The question is whether this may be relied upon by liquidators to claw back monies that have been paid out.

7. It should also be noted that a widespread practice is to use administrators to calculate the NAV, who may in turn rely upon investment managers acting independently of the directors for information as to the value of a fund's assets. As we discuss further below, this can give rise to difficult questions of attribution if the administrator relies in good faith upon fraudulent representations made by an investment manager.

FALSE DECLARATIONS OF NAV

Restitution for mistake

8. Under Cayman law (which in this regard is identical to English law), the payment of monies to another under a qualifying mistake of fact or law is recoverable in restitution (*Barclays Bank v Simms* [1980] QC 677; *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349). To qualify such mistake must be causative and of such a nature as to render it unjust on the part of the donee to retain the monies transferred.

9. At first glance this would appear to be an extremely useful cause of action for a liquidator seeking to claw back monies. There can be little doubt that the NAV struck was ascertained on the basis of a mistake as to the company's true financial position and it was obviously causative given that the redemption payment was calculated by reference to it.

10. Notwithstanding this, an apparently insuperable hurdle to such claims has been held to exist as a result of the caveat in *Kleinwort Benson* that *"the payee of money cannot be said to have been unjustly enriched if he was entitled to receive the sum paid to him"* (at 408).

11. In *Fairfield Sentry (in liquidation) & Ors v Migani & Ors* [2014] UKPC 9 this was relied upon for the proposition that there can be no recovery *"to the extent that a payment made under a mistake discharges a contractual debt of the payee…unless…the mistake is such as to avoid the contract"* (paragraph [18]).

12. In the context of an investment company with the characteristics described above, Lord Sumption (giving the judgment of the Privy Council on appeal from the British

Virgin Islands) held that provisions in the articles of association stipulating that calculations of net asset value by the directors were binding meant that it was of no consequence if subsequent events showed such calculation to be wholly fictitious. Instead, the proper construction of such provisions was that each shareholder had an entitlement to receive a redemption payment determined by reference to the NAV calculated at the time of redemption, rather than on the basis of the true NAV taking into account Bernie Madoff's frauds.

13. In support of this conclusion Lord Sumption pointed to the commercial context in which such provisions operated. In particular, his Lordship noted that *"…once the NAV per share for a given monthly Valuation Date is ascertained, subscriptions and redemptions effected at the corresponding Subscription and Redemption Price will affect the determination of NAV per share on the following monthly Valuation Date. This is because the receipt of subscription moneys and the payment out of redemption moneys will affect the amount of the Fund's assets… It will be apparent from this summary that the whole of this scheme depends upon the price being definitely ascertained by the Dealing Day and known to the parties shortly thereafter. It is unworkable on any other basis"* (paragraph [21]).

14. *Fairfield Sentry* was applied by Andrew Jones J in *Primeo Fund v Pearson* (unreported, 12.vi.2015).

14.1. The Plaintiff in *Primeo* was an open-ended investment fund which held shares in Herald Fund SPC, itself an open ended investment fund which had invested the whole of its funds in Bernard L Madoff Investment Securities (**"BLMIS"**).

14.2. The issue before the Grand Court arose in the context of Section 112(2) of the Companies Law and Rule 2 of the Companies Winding Up Rules, the combined effect of which is to require a liquidator in a solvent liquidation to rectify the register of members if the company in question has issued or redeemed shares at prices based upon a misstated NAV which is not binding[2].

14.3. One of the liquidator's arguments before Andrew Jones J (which was not pursued on appeal) was that the NAV determination was not binding because it had been calculated by Herald's administrator and directors in reliance upon representations

[2] While *Primeo* was therefore not a clawback claim, the reasoning of Andrew Jones J vis-à-vis the circumstances in which a determination of NAV would not be binding are equally applicable where this issue arises in the context of claw back.

made by BLMIS which were fraudulent, thereby giving rise to a chain of delegation through which BLMIS's fraudulent intent could be attributed to Herald (see paragraph [38]).

14.4. Andrew Jones J disagreed, holding that Herald and its directors were themselves victims of the external fraud of BLMIS, and that this prevented the attribution of BLMIS's fraudulent intent to Herald. Only if Herald or its directors had themselves perpetrated an *"internal fraud"* by themselves misstating the NAV in bad faith would this make the NAV non-binding (paragraphs [39]-[42] and [50]).

14.5. Andrew Jones J also rejected an argument based upon Herald's articles which stated that a determination of NAV would not be binding if there was a manifest error on the face of the certificate. In Andrew Jones J's view this could only be demonstrated if the error was readily apparent at the time the certificate was issued. In circumstances where the NAV was only shown to have been false by subsequent events, this was self-evidently not the case (paragraph [45]).

Vitiation by bad faith

15. The extent to which an internal fraud leading to the determination of NAV in bad faith can vitiate the binding nature of such determination was considered further by Andrew Jones J in his very recent decision in *Re Palm Beach Offshore Limited* (unreported, 21.i.2016).

15.1. In that case an investor in Palm Beach Offshore Limited, a Cayman open-ended investment company, appealed the liquidator's rejection of its proof of debt in respect of a redemption payment calculated by reference to a NAV struck prior to the discovery that all of Palm Beach's investments were in promissory notes issued by entities that formed part of an elaborate Ponzi scheme.

15.2. The executive directors of Palm Beach also wholly owned its investment manager while the non-executive directors were found to have played a minimal role and acted at all times in accordance with the instructions of the executive directors.

15.3. Calculations of Palm Beach's NAV were performed by its administrator on the instructions of its executive directors acting in their capacity as investment managers. In the absence of any exercise of independent judgment by the administrator, Andrew Jones J accepted that any dishonesty of its executive directors would be imputed to Palm Beach. We return to the question of attribution below.

15.4. As is common, the articles of Palm Beach rendered a calculation of NAV struck in good faith binding upon the Company and its shareholders. Andrew Jones J held that to be in bad faith, it would need to be established that the executive directors' behaviour was *"so obviously improper and commercially unacceptable that they must be regarded as deliberate and dishonest. It is not sufficient to show that they were merely careless or negligent"* (paragraph [18]).

15.5. On the basis of findings reached without live evidence from the executive directors, and primarily on the basis of admissions made by them in SEC proceedings, Andrew Jones J did not consider that this test was satisfied. In particular, he was satisfied that the executive directors had not known about the Ponzi scheme and that confessed failings on their part properly to disclose facts about Palm Beach's business only demonstrated carelessness.

15.6. Significantly, on the strength of English authority, including the decision of the English Court of Appeal in *WestLB AG v Nomura Bank International plc* [2012] EWCA Civ 495, Andrew Jones J further considered that even if he had concluded that the NAV had been struck in bad faith, his task was not to determine what the NAV actually was, but instead to put himself in the shoes of the directors and ask what value they would have put on Palm Beach's investments acting in good faith, and what NAV the administrator would have calculated in good faith as a result. On this basis, anything that happened after the date the valuation was supposed to have been conducted was irrelevant (paragraph [41]).

16. The high threshold for establishing bad faith, and the limited counterfactual inquiry that the Court is prepared to make even if it is established, demonstrate that considerable difficulties will be faced by a liquidator seeking to show that a fictitious NAV ought to be replaced by one struck on the basis of the true facts.

17. Furthermore, Andrew Jones J's assumption that the intention and knowledge of those acting dishonestly in relation to the calculation of NAV may be attributed to the companies was doubted by Clifford J in *Weavering* (unreported, 4.xii.2015). In reliance upon the decision of the Supreme Court in *Jetivia SA v Bilta (UK) Limited* [2015] UKSC 23, and in particular the speech of Lord Mance, Clifford J held that where a director or other person involved in the decision making of the company is acting for the purpose of defrauding the company itself, it is open to the company to disclaim such attribution. This is so even if the company wishes to rely upon that same person's knowledge for some other purpose (paragraphs [129]-[130]).

18. On the facts of *Weavering*, this meant that the knowledge of Mr Magnus Peterson (who had effectively controlled the company through its investment manager) was not to be attributed to the company insofar as he had falsely represented the value of its investments, but could be attributed to it in relation to the question whether certain redemption payments had been made preferentially (considered further below).

19. In the authors' view this disclaiming of attribution goes somewhat beyond the *ratio* of *Jetivia*.

19.1. The Supreme Court in that case were only concerned with the question whether the dishonest and illegal knowledge and intentions of a director could be attributed to a company in circumstances where the company was pursuing claims against such director.

19.2. While all of their Lordships bar Lord Sumption suggested that the appropriateness of attributing knowledge and intention would depend on the circumstances of any given case, they certainly did not go so far as to say that a dishonest intention of a director (or other controlling mind) who was defrauding the company would not be attributed to it in every case (see paragraphs [7]-[9], [39]-[45] and [202]-[209]).

19.3. Further, Lord Sumption (at paragraphs [65]-[93]) considered that in general the dishonest intention and knowledge of a director or other controlling mind <u>would</u> be attributed to the company save in the specific context of claims brought by the company against that person where such attribution was relied upon by way of defence.

20. While not of direct relevance to his decision, it is also material to note that in *Weavering* Clifford J endorsed in passing a submission to the effect that even if it were possible to establish that the NAV had been calculated fraudulently, and that such fraudulent knowledge could be attributed to the company, *Fairfield Sentry* stands for the proposition that the NAV is nevertheless binding in the context of a clawback claim (paragraph [125]).

21. The authors do not accept that this is correct, and are of the opinion that *Fairfield Sentry* is distinguishable in this context because in that case those involved in the calculation of the NAV had acted honestly, if mistakenly.

22. Notwithstanding this, it must be recognised that the high hurdle for establishing bad faith, the difficulties of attribution of dishonest intention and knowledge to the company and the limited counterfactual inquiry that the court is willing to make mean

that succeeding in a clawback claim based upon a NAV struck in bad faith will be an uphill struggle.

VOIDABLE PREFERENCES

23. A line of attack which had an unpromising start, but which has more recently been successfully deployed, is to seek to reclaim redemption payments made to earlier investors on the basis that there has been a voidable preference.

24. Under s.145 of the Companies Law payments made *"with a view"* to giving a creditor a preference over other creditors shall be invalid if they take place six months immediately preceding the commencement of a liquidation. This test replicates that which existed in England prior to the changes brought about by the Insolvency Act 1986. As such, it is still necessary in Cayman to show a dominant intention to prefer (as opposed to a desire to produce such an effect under the English test), albeit that this may be inferred from the circumstances in both England and Cayman.

25. Furthermore, in both England and Cayman, if it can be shown that a creditor was paid because it had brought pressure to bear on the company (rather than because the company actually wanted to improve the creditor's position in an insolvency) this will be a good defence to a preference claim.

26. This principles were recently restated and applied by Smellie CJ in *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund* (unreported, 17.xi.2014)[3]. As the Chief Justice stressed, it is not enough to show knowledge that the company is or will become insolvent and that the net effect will be to prefer the creditor in question. Instead the Court must ascertain:

    "...whether the dominant intention was to prefer (in the sense of deliberately paying out of turn being aware of the consequences for those other creditors not paid) or whether payment may have been motivated by other concerns typically of the debtor himself, which are not impelled predominantly by an intention to prefer the creditor, even if the preference is the consequence of that payment".

27. On the facts of *DD Growth* this test was not satisfied because the evidence showed that the redeeming investor had been paid in response to his *"unrelenting and escalating pressure"* in the face of *"an equally consistent effort at prevarication and*

[3] The Chief Justice's decision was on s.168 of the 2007 Revision under which the test is, in substance, the same.

evasiveness on the part of the [fund]*"*. Such pressure took the form of a threat to involve the regulatory authorities and to take legal action.

28. In the authors' view, this decision was undoubtedly right on orthodox preference principles under Cayman law. Indeed, the Chief Justice's decision was squarely based on the longstanding and oft-cited judgment of Lord Evershed MR in *Cutts (A Bankrupt) ex parte Bognor Mutual Building Society v Trustees of TW Cutts* [1956] 1 WLR 728 in which the Master of the Rolls held:

    "…if a debtor deliberately selects for payment A in preference to all his other creditors, it cannot, to my mind, matter in the absence of other relevant circumstances, whether A is the debtor's oldest friend, closest relative or best client. On the other hand, where a debtor, owing money in all directions, has also robbed his employer's till, he may, knowing himself to be insolvent, elect to reimburse the till in order that, when the crash comes, the damaging fact of his robbery may not be discovered. Or a debtor may elect to make a particular payment under pressure of some threat, or to obtain for himself some immediate and material benefit or to fulfil some particular obligation. In these cases the reason for the payment affects, essentially, the intention in making it. In the instances given the intention, that is the real or dominant intention, will no longer be to "prefer"(that is to pay, as it were, out of turn) but will be to avoid the detection of a criminal act, to relief the threat; to get the benefit and postpone the evil day; or to satisfy the particular obligation"

29. Notwithstanding this pedigree, there is a credible argument to be made that this approach to preferences leaves the law in an unsatisfactory state. In terms of disruption to *pari passu* disruption, undesirability from the perspective of insolvency policy and the conferring of unjustified windfalls, why should a creditor who threatens to blow the whistle unless paid, and who once paid allows the wrongdoing to continue, escape a clawback claim? Is his position really more attractive than that of a close business associate whose loyalty the debtor company wishes to reward by making payment first?

30. For those who would wish to see clawback claims based upon voidable preferences play a more prominent role, the recent decision of Clifford J in *Weavering* provides some comfort.

    30.1. In that case the decisive factor proved to be evidence demonstrating that Mr Magnus Peterson had directed certain investors to be paid out first because they were going to reinvest their monies in a further *Weavering* firm. Because Mr Peterson's knowledge and intentions were held to be attributable to the company for these purposes, this was said to establish a dominant intention to prefer (paragraphs [174]-[180].

30.2. Perhaps more significantly (albeit *obiter*), Clifford J further held that in circumstances where a company is approaching insolvency, it is permissible to infer that payments to creditors for which no explanation is provided were made with a dominant intention to prefer. That said, Clifford J nevertheless felt that

> *"In such cases it can be anticipated that there will have to be weighed against such inference any other particular reasons in those individual cases why payments were made, such as pressure being brought to bear. It may also be necessary to consider whether, perhaps, the evidence is equivocal.*
>
> *Balanced against any inference of preference, it may have to be considered whether payments were simply made at random, or perhaps to play for time to keep the Company going, in the hope of Magnus Peterson to avoid detection of his fraud for as long as possible"* (paragraphs [188])

31. The final part of Clifford J's judgment which warrants mention is his conclusion that a claim based on s.145 of the Companies Law is not a claim in restitution. As a result no change of position defence was said to be available. Instead, according to Clifford J *"The specific effect of a payment falling within s.145 is that it is "invalid" and the effect of this can only sensibly mean, in my view, that the recipient has to pay back an equivalent sum of money to that received…Furthermore, the important point to make is that there is no discretion in the Court to make any other order"* (paragraph [211]).

32. The reasoning of Clifford J may be open to question in a suitable future case. It is true that s.145 does not confer upon the Court a remedial discretion such as that enjoyed under s.239 of the Insolvency Act 1986 which permits the Court to make such order as it thinks fit. However, rather than pointing to the existence of a blunt statutory requirement to repay in full, the effect of an absence of any statutory remedial regime may instead simply mean that common law remedies remain available. Authority for this proposition may be found in the decision of the Privy Council in *Kiriri Cotton Co Ltd v Dewani* [1960] AC 192 at 205-206.

33. While restitutionary and other common law remedies may not exist under statutes which are passed for purposes other than protecting persons in the position of the claimant (*Green v Portsmouth Stadium Ltd* [1953] 2 WLR 1206), the prohibition on voidable preferences is clearly design to safeguard a company's assets for the benefit of its creditors and shareholders.

34. As a result there is no good reason why a liquidator should not be able to pursue common law remedies in the event that a transaction is rendered voidable by the operation of s.145.

Hugh Dickson
Grant Thornton

Matthew Morrison
Serle Court Chambers