The Wobling Fund – A Crypto Case Study
Notes on some recent relevant insolvency and fraud cases

A. Primeo

Pearson v. Primeo Fund (Cayman Islands) [2017] UKPC 19

Privy Council upholds decisions of the Grand Court and Court of Appeal of the Cayman Islands that redeemed but unpaid fund investors are to be treated as creditors in a liquidation, with claims which rank ahead of the claims of unredeemed investors (i.e. shareholders) but behind other unsecured creditors.

Facts in brief summary

Primeo Fund invested indirectly in the Madoff main fund via Herald Fund SPC, a Madoff feeder fund in which investors acquired redeemable shares in Herald, a Cayman company. Primeo submitted redemption requests for a redemption date of 1 December 2008. On 11 Dec 2018 Madoff fraud comes to light and Herald immediately suspended the determination of NAV and, subsequently, the payment of redemption proceeds to (inter alios) Primeo. 2013 Herald goes into liquidation while suspension remains in place.

The Proceedings

Section 37(7) of the Companies Law (2007 Revision) of Cayman (the 2007 Law) provides the redemption of shares which "are to be redeemed" or "are liable to be redeemed" but have not been redeemed before the commencement of the liquidation, may only be enforced if (a) the terms of the redemption provided for it to take place at a date earlier than the commencement of the winding up and (b) the company could have lawfully distributed the redemption proceeds prior to the commencement of its liquidation. The key issue was whether or not section 37(7) applied at all to Primeo had it already redeemed its shares by the commencement of the liquidation and hence whether s.37.7 applied to it.[1]

At first instance, the Grand Court, held Primeo's shares had been redeemed pursuant to Herald's articles, and so they fell outside the ambit of s.37(7). CICA agrees, holding a redeemed investor's claim for unpaid redemption proceeds was a provable claim falling within s.139(1) of the 2007 Law and that a claim for unpaid redemption proceeds falls within s.49(g) of the 2007 Law. Result is that Primeo's claim is payable in priority to the claims of unredeemed investors but ranked behind the claims of ordinary, unsecured creditors.

The Decision

The Privy Council upholds CICA as matter of construction of s.37(7) redemption is a point in time established primarily by reference to the company articles when shareholder rights cease, not a process including determining NAV and paying proceeds so determined. JCPC also agree re effect of s.49(g). Two groups of investors who submitted redemption requests later than Primeo had intervened in appeal. They are held to be caught by s.37(7), again as matter of construction of Herald's articles.

Comment

A victory for freedom of contract, provided those drafting fund documentation understand the meaning of statute. Regarded as good for funds.

[1] See Companies Law 1991 (Jersey) art. 55 for Jersey law on redeemable shares.

B. Weavering – preferences claim

S.E.B v Conway [2019] UKPC 36.

The Privy Council holds that redemption payments received by SEB from Weavering Macro Fixed Income Fund Ltd shortly before its liquidation constituted voidable preferences and requires SEB to repay the same to Weavering's liquidators.

Facts in brief summary

Weavering was an open-ended Cayman investment fund, operated through a Cayman company offering redeemable shares to investors. It went into liquidation on 19 March 2009 on discovery of fraud by the principal of the Company's investment manager. SEB (a bank) had subscribed for approximately US$9.5 million of redeemable participating shares in the Company as nominee for two clients. In October 2008, shortly after the collapse of Lehman Brothers, SEB gave redemption notices in respect of all of the shares it held as nominee for its clients, for a 1 December 2008 redemption date. Between 19 December 2008 and 11 Feb 2009 SEB received US$8.2 million in redemption payments which it paid over to its clients. By the time Weavering went into liquidation some investors who had redeemed at the same time as SEB had received a substantially smaller proportion of the money due to them and investors who attempted to redeem for later redemption dates had not received any of the sums due.

The Proceedings

Weavering's liquidators issued proceedings against SEB seeking a declaration that the redemption payments were invalid as preferences under section 145(1) of the Companies Law (2013 Revision) of Cayman (2013 Law) and an order that the monies be repaid with interest.

Section 145(1): *"Every conveyance or transfer of property… made… by the company in favour of any creditor at a time when the company is unable to pay its debts… with a view to giving such a creditor a preference over the other creditors shall be invalid if made… within six months immediately preceding the commencement of the liquidation."*[2]

The liquidators won at first instance and on appeal by SEB to the CICA. SEB appealed.

The Decision

The Privy Council held:

a. Dissenting from the CICA, that as the NAVs were the result of an internal fraud by Weavering's controlling mind, rather than as a result of a fraud against the fund, they did not bind shareholders and were voidable. However a party seeking to have the NAVs held void would need bring a claim vs the liquidators, asserting it had suffered loss due to that fraud. SEB received payments because of the fraud and so it was not a victim and could not argue against the accuracy of the NAVs.

b. The liability of Weavering to pay December Redeemers crystallised on 1 December 2008 (rather than 30 days later) so the fund was insolvent on that date.

c. S.145(1) of the 2013 requires a 'dominant intention to prefer' to be proved but CICA had been entitled to find that this was the case on the facts.

d. Contrary to CICA's holding on the point, that s.145 (unlike its English equivalent IA 1986, s.239) does not create a statutory right to recover the property or payment which were the subject of the preference, but instead renders the relevant transfer or payment voidable. The result was that the liquidators' claim to recover was based on common law restitution and not statutory.

[2] See Bankruptcy (Désastre) (Jersey) Law 1990, Arts 17, 17A and 17B.

e. SEB's defence based on lack of unjust enrichment failed on the facts on the footing that it acted as principal/trustee and not as agent. A trustee was held to be unjustly enriched by receiving a payment as legal owner, even when it holds the sum in question, and the underlying right to receive that sum, on bare trust for its beneficiary.

f. Nevertheless, change of position was not available as a defence to SEB on policy grounds, as in the event a transaction was avoided under s.145, the principle of *pari passu* distribution between creditors overrode any unfairness to the preferred creditor in repaying the money received.

Comment

The potential for defrauded investors to overturn NAV calculations where they are the result of a fraud in the fund (and not on the fund) is significant, as is the denial of a change of position defence to custodians acting for clients who receive payments from wobbling funds. In the case of the collapse of a Jersey trust law based fund (such as the Wobling Global UT), focus would likely be on the terms of the trust instrument regarding the redemption of units and on applying both traditional and modern trust law to the "insolvency" issues raised.[3]

C. Marex

Sevilleja v Marex Financial [2018] EWCA Civ 1468

Victims of a fraud could not sue its author where they are unsecured creditors of a company controlled by the fraudster that has suffered the "same loss".

Facts in brief summary

In ongoing English proceedings Marex accuses Mr Sevilleja of asset-stripping two companies, so that they were unable to pay their judgment debt to Marex, by transferring money from their bank accounts to his personal control. Marex says that in doing so, Mr Sevilleja committed a tort. On this basis, it obtained permission to serve proceedings on him out of the jurisdiction.

The Decision

The Court of Appeal held, in Mr Sevilleja's favour, that a company's unsecured creditor could not bring a claim against the company's fraudulent director in tort, as this would be contrary to the reflective loss rule - originally that a shareholder could not sue for a loss based on the damage to the value of his shares where the company had a claim for that "same" loss against a third party. The theory being that the company should be able to pursue the claim for the benefit of all its creditors to the exclusion of claims by others (again preferring the *pari passu* principle applicable to distributions on insolvency to the claim or detriment of a particular creditor).

Marex's appeal to the Supreme Court was heard on 9 May 2019 and **judgment is awaited**.

Comment

The English courts continue to grapple with the impact of fraud by those who run a company on claims by the company against others and against those individuals responsible for the fraud. This decision has some potentially alarming consequences and the principle is in itself open to question particularly in jurisdictions such as Jersey where many structures involve a company held under a trust under common control, which, applying the reflective loss rule, would potentially leave trust beneficiaries without a claim, which in context is not a readily acceptable outcome. The judgment of the Supreme Court may provide an opportunity to go back to first principles and to consider whether the reflective loss rule should have a narrow or a broad scope.

Mark Hubbard, New Square Chambers, November 2019

[3] See e.g. the *Re Z Trusts* decisions: [2015] JRC 031, [2015] JRC 196C, [2015] JRC 214 and [2018] JRC 119 and *Re MF Global UK Ltd* [2013] 1 WLR 3874.