Using estate funds to resolve questions of priority: The Grand Court of the Cayman Islands provides clarity on procedural mechanisms and costs within liquidation proceedings

February 2023

Introduction

The Grand Court of the Cayman Islands (**Court**) has recently handed down the decision of Mr Justice Segal in *Re Direct Lending Income Feeder Fund, Ltd (in official liquidation)*[1] (***Direct Lending***) which will be of interest to both officeholders and stakeholders in liquidation proceedings where the determination of stakeholders' substantive rights is not straightforward.

The decision highlighted the flexibility of Order 11 of the Companies Winding Up Rules (**CWR**) as a procedural tool to assist in the determination of stakeholders' substantive rights. It also provided guidance on the nature of officeholder and stakeholder participation in such applications and, importantly, the costs burden of stakeholder participation.

The decision confirmed that the Court's determination as to the correct procedural route is likely to hinge upon the true nature of the relief sought and the extent to which stakeholders are participating primarily to advance their own interests. The decision also indicates that the more appropriate it is for an issue to be determined as *inter partes* proceedings under CWR Order 11 rule 3 (3), the less likely it is that a participating stakeholder will be afforded the comfort of a pre-emptive order that its costs be paid out of the interests of the estate.

Background

Direct Lending Income Feeder Fund (**DLIFF**) is part of a typical Master-Feeder structure, which invested (alongside a US-based feeder fund) into a US-based master fund (DLI Capital Inc.) under the management of Direct Lending Investments, LLC (**Manager**). Following the commencement of receivership proceedings in the US, encompassing both feeder funds, the master fund and the Manager, DLIFF was placed into official liquidation in 2019.

As part of the process of distribution of the assets of DLIFF, its joint official liquidators (**JOLs**) will need to resolve four categories of core issues in order to determine the substantive rights of DLIFF's investors (**Investors**). Two of these categories of issues (the **Misrepresentation Issues** and the **Late Subscriber Issues** respectively) will require resolution in any event. The other two categories might or might not require resolution, depending on the outcome of the Misrepresentation Issues.

This recent decision does not address the substantive issues themselves but was concerned with the appropriate procedural route(s) for their resolution.

The JOLs' application and the procedural issues

The JOLs commenced an application under Order 11 of the CWR, seeking directions from the Court regarding the exercise of their discretion within the adjudication process. The JOLs identified the directions sought in relation to Misrepresentation Issues and the Late Subscriber Issues as the **Priority Relief**.

The JOLs proposed directions whereby they would appear and advocate for the Priority Relief while Investors would be permitted to appear to oppose (or support) the Priority Relief at their own risk as to costs.

This proposed procedural approach was supported by the liquidation committee. However it was opposed by an investor, Eiffel eCapital US Fund (**Eiffel**), which indicated that it intended to oppose the substantive relief in respect of the Misrepresentation Issues. In reliance upon the directions given by Smellie CJ in *In re SPhinX Group*[2], Eiffel proposed (inter alia) that:

- the Priority Relief should be determined as *inter partes* proceedings as between the relevant classes of stakeholder;
- representation orders should be made appointing a representative for each class of stakeholder; and
- Eiffel, as a representative opposing the substantive relief in respect of the Misrepresentation Issues, should have the benefit of a pre-emptive costs order such that it could proceed with the knowledge that its reasonable costs will be paid, in any event, out of the assets of the estate.

Eiffel's approach was supported by its affiliates and another similarly-positioned investor, as well as some investors for whom the Late Subscriber Issues were of primary interest.

The Court's analysis of the legal principles

Mr Justice Segal summarised the three main procedural routes by which the substantive issues could be brought before the Court in a winding up by the liquidators[3]:

- First, the official liquidators may adjudicate a creditor's proof in accordance with CWR Order 16. If, following a rejection of a proof, a creditor appeals, it will be at risk as to costs (i.e. faces having to pay both its and the liquidators' costs if it loses)[4].
- Second, the official liquidators may make a sanction application in which they apply for an order giving them permission to exercise their powers in a particular manner and an interested contributory or creditor may be joined as a respondent to make submissions on behalf of contributories or creditors in a similar position. The general rule is that a participating stakeholder will be at risk as to its own costs (but not that of the liquidators), but if there are exceptional circumstances and special reasons justifying doing so, the Court may disapply the general rules and make "*some other order or not [sic] [no] order for costs*" [5].
- Third, the official liquidators may make a sanction application in which they apply for an order giving them permission to exercise their powers in a particular manner and the application "*gives rise to an issue in respect of the [sic] substantive rights as between the company and any creditor or contributory or any class thereof*" [6]. The Court may then direct that the proceeding is adjudicated as *inter partes* proceedings as between shareholders, creditors or any class of shareholders or creditors, for which purpose the Court may make a representation order and give directions to the official liquidators as to the role (if any) they should take on the application [7]. Then, if "*in substance, the application [becomes] litigation between [the*

relevant parties]" where neither of them can be said to have been acting in the interests of the estate then the Court may and should disapply the general rules set out in CWR O.24, r.9(4) – i.e. each party should expect to be at risk as to the costs incurred by itself and its opponent(s).

Mr Justice Segal observed that the Court's decision as to the appropriate procedure will depend upon the nature of the issues in dispute, and the need to achieve the following objectives[8]:

- the dispute should be resolved fairly in accordance with the overriding objective;
- the parties in interest should be given an opportunity to be heard;
- the liquidation estate should only bear the costs of the proceedings where they are, and where those who appear are acting, for the benefit of the estate.

Mr Justice Segal noted in particular the decision of Kekewich J in *Re Buckton[9]* (and the subsequent judicial treatment of and commentary on that decision[10]) and the need to analyse whether the litigation (or application) had the character of a hostile claim which is brought not in substance for the benefit of the estate, but for the benefit of the stakeholder, and is resisted for a similar reason.

Noting the flexibility afforded to the Court under the CWR, Mr Justice Segal concluded that the Court should only make an order that the issues be adjudicated as *inter partes* proceedings where "*considering all relevant factors, the litigation is properly to be categorised as being in substance hostile litigation in which the dispute is exclusively or primarily between (or for the benefit of) stakeholders who are to be treated as litigating for their own benefit and not for the benefit of other stakeholders (creditors or contributories) or to assist in the administration of the winding up*".[11]

Mr Justice Segal's decision included the following observation, which indicates that the circumstances in which stakeholders can expect a liquidation estate to pay for the resolution of an issue properly determined as *inter partes* proceedings would be severely limited (if not impossible):

"I would note that while [the stakeholder] has strongly argued for the Misrepresentation Issues to be adjudicated as an inter partes proceeding between the Investor groups it has identified, it appears not to accept the consequences of adopting such an approach. If this approach were to be adopted, the Investors concerned would be acting in their own interests and the usual rules as to costs would need to be applied."

Accordingly, the more likely it is that the issues are properly determined as *inter partes* proceedings, the more likely it is that stakeholders will have been determined to be acting primarily in their own interests and should expect to be at risks as to costs.

In relation to the role properly undertaken by the JOLs, Mr Justice Segal noted (in reliance upon *SPhinX* and *Re Belmont Asset Based Lending Ltd*[12]) that "*the general rule is that official liquidators should adopt a neutral stance where there is a dispute between creditors or contributories*" and that there must be a sufficient reason to justify departure from that rule if the JOLs are to actively argue for relief that affects the rights of stakeholders[13]. Mr Justice Segal confirmed as follows[14]:

"Where there are uncertainties as to the substantive rights of those with claims against or as entitlements as shareholders to the estate, which in substance give rise to disputes between stakeholders, the costs of resolving such disputes should generally be for those stakeholders and not the estate and the JOLs should remain neutral as between them."

The Outcome

On the facts, Mr Justice Segal considered that a different procedural approach was required for the Misrepresentation Issues and the Late Subscriber Issues. The distinction was based upon the nature of the relief sought and, critically, the certainty of the interests of the respective stakeholders.

In relation to the Misrepresentation Orders, Mr Justice Segal noted that the uncertainty of the economic interests meant that participating stakeholders can properly be treated as not acting just for themselves and their own benefit but rather for the purpose of facilitating the resolution of an issue that needs to be determined in order to allow the JOLs to make progress in the liquidation. Their participation would thus assist in the administration of the liquidation estate. Mr Justice Segal observed thus: "*In these circumstances, in a case involving what can be treated as an application sponsored by the JOLs to assist them in carrying out their functions, it would in my view not be appropriate to treat the dispute over the Misrepresentation Orders as involving only or primarily the separate interests of the misrepresentation creditors and those selected to oppose the application … The position would be different if the interests of particular Investors or groups of Investors were crystallised and clearly ascertainable.*" ***[15]***

Accordingly, in relation to the Misrepresentation Issues, Mr Justice Segal concluded that (inter alia):

- an order for either *inter partes* proceedings or a representation order was not justified;
- it would be proper, in the circumstances, for the JOLs to actively participate for the relief sought;
- Eiffel's participation in opposing the relief was necessary to enable the application to proceed and would be for the benefit of the liquidation estate;
- Eiffel should have the benefit of pre-emptive costs order: "i*f the JOLs' active participation is justified because the application is not suitable to be adjudicated as an inter partes proceeding and is for the benefit of the estate, it would be wrong in principle to put the opposing party at a costs disadvantage and to deprive it of the costs protection to which parties are entitled when participating in proceedings at the request of the official liquidators for the benefit of the liquidation and the liquidation estate*".

By contrast, Mr Justice Segal concluded that the Late Subscriber Issues are properly determined via *inter partes* proceedings with each party at costs risk, and he observed:

*"It seems to me that the opposition to the application for the Late Subscribers Contract Orders does in substance, when properly characterised, involve a hostile claim by (or for the benefit of) the Late Subscribers in their own interests so that it would not be acceptable for the Late Subscribers to be paid out of the liquidation estate if they are unsuccessful. And any Investor who wishes to support the making of the Late Subscribers Contract Orders would be doing so in its own interests and should bear the costs of doing so if unsuccessful … The [Late Subscriber Issues] give rise to case and fact specific disputes where the interests of Late Subscribers and other Investors are clearly defined and which should be resolved as between and at the expense of the affected and adverse parties."****[16]***

References:

[1] *Re Direct Lending Income Feeder Fund, Ltd.* (Unreported, Justice Segal, 10 November 2022, Cause No: FSD 108 of 2019 (NSJ))

[2] [2010] 2 CILR 1

[3] See paragraph 83 of the judgment

[4] CWR O.24, r.10(3)

[5] CWR O.24, r.9(4) and (5)

[6] CWR O.11, r.3(3)

[7] CWR O.11, r.3(3)(b) and (c)

[8] See paragraphs 85 – 86 of the judgment

[9] [1907] 2 Ch. 406

10] Lewin on Trusts (20th ed., 2020) at [48-039]

[11] See paragraph 91 of the judgment

[12] [2011 (2) CILR 484]

[13] See paragraph 105 of the judgment

[14] See paragraph 120 of the judgment

[15] See paragraph 99 of the judgment

[16] See paragraph 117 of the judgment

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