Houldsworth is worth holding onto: Recent Cayman case, DLIFF, highlights complexity of misrepresentation claims in a liquidation

March 2024

Introduction

In a detailed decision of Mr Justice Segal in Re Direct Lending Income Feeder Fund, Ltd (in official liquidation)[1] (***DLIFF***), handed down on 13 March 2024, the Grand Court has determined that claims of investors in companies whose subscriptions were induced by misrepresentation by the company (**Subscriber Misrepresentation Claims**):

(a) are admissible to proof in liquidations; and

(b) if admitted, are subordinated to unsecured debts and rank *pari passu* with other subordinated claims such as redemption creditor claims.

The DLIFF decision addresses many of the same issues addressed in a decision of Mr Justice Doyle in *Re HQP Corporation Ltd (in official liquidation)*[2] (***HQP***), handed down on 7 July 2023. However, the decisions differ in their analysis on admissibility and in their characterisation of the Subscriber Misrepresentation Claims.

Whilst the different approaches on admissibility do not give rise to a different practical outcome on that issue (in that both decisions concluded that Subscriber Misrepresentation Claims were admissible), the decisions differ as to the priority to be afforded to such claims in the distribution waterfall in liquidations, with potentially significant economic consequences.

The Grand Court decision in *HQP*

In *HQP*, Mr Justice Doyle concluded that the decision of the UK House of Lords in Houldsworth v City of Glasgow Bank[3] can no longer be regarded as good English law and it is not part of Cayman Islands common law.[4] In relation to the question of the characterisation of Subscriber Misrepresentation Claims, i.e. whether such claims are made in the shareholder's character as a member, Mr Justice Doyle held that they are not made in the shareholder's character as a member and section 49(g) of the Cayman Islands Companies Act did not apply to such claims.[5] Mr Justice Doyle found the reasoning of Gummow J and Hayne J of the High Court of Australia in Sons of Gwalia Ltd v Margaretic & Anor[6] highly persuasive, and thus he necessarily departed from the obiter remarks of Lord Browne-Wilkinson in the House of Lords decision in *Soden v British & Commonwealth Holdings plc* **[7]** (which indicated that such claims were made in the shareholder's character as a member).

The Grand Court decision in *DLIFF*

In an earlier decision on procedural issues in the DLIFF proceedings[8], the Court had directed that DLIFF's Joint Official Liquidators (**JOLs**) would advocate for the grant of the following orders (the **Misrepresentation Orders**):

· an order that the JOLs be directed to exercise their function of adjudicating claims on the basis that any Subscriber Misrepresentation Claims from investors of DLIFF were not barred as a matter of law solely due to the fact that DLIFF was in liquidation; and

· an order that, in the event that any Subscriber Misrepresentation Claims from investors of DLIFF were admitted, the JOLs be directed to pay such claims either (i) *pari passu* with any admitted Redemption Claims, or, in the alternative, (ii) in priority to any admitted Redemption Claims.

The Court had also directed that a redemption creditor, Eiffel eCapital US Fund, would advocate against the granting of the Misrepresentation Orders.

In its substantive decision, following a 2-day hearing in May 2023, the Court approached the question of admissibility by examining the principle emanating from *Houldsworth* and subsequent judicial decisions as a "no-proof proposition". The Court determined that this "no-proof proposition" amounted to a rule that prevented a subscribing shareholder (who had not rescinded prior to the commencement of the winding) from proving in a winding up for damages for misrepresentation.

However, the Court considered that this prohibition was necessarily qualified in that it only operated to prevent Subscriber Misrepresentation Claims from competing with claims of non-member creditors (see e.g. [11 (c)] and [167]). The Court determined that the "no-proof proposition", properly formulated, is soundly based upon capital maintenance principles and is good law in England and the Cayman Islands (see e.g. [210] and [217]). Further, it operates in tandem with the statutory subordination under section 49(g) of the Companies Act.

On the question of the characterisation of Subscriber Misrepresentation Claims under section 49(g), Mr Justice Segal took a different view to Mr Justice Doyle, and preferred the analysis of Lord Browne-Wilkinson and the "corporate nexus" rationale expressed by Robert Walker J's at first instance in *Soden* over the rights-based analysis of the High Court of Australia in Sons of Gwalia Ltd. Considering that the substance of the claim is to recover the financial equivalent of the shareholders' capital contribution, which contribution arises because of his/her status as a member, the Court determined that a purposive interpretation of section 49(g) led to a conclusion that Subscriber Misrepresentation Claims are made in the claimant's character as a member (see [260]).

Having determined that Subscriber Misrepresentation Claims were subordinated to non-member creditor claims pursuant to section 49(g), the Court addressed the argument that Subscriber Misrepresentation Claims were further subordinated to the claims of redemption creditors. The Court rejected this argument, determining that admitted Subscriber Misrepresentation Claims would rank *pari passu* with admitted redemption creditor claims.

Conclusion and comment

The distinction between the Grand Court decisions emphases the complexity of the issues that are fundamental to the stakeholders' economic interests in the two liquidations.

The practical consequence of the differing decisions of the Grand Court is that – for the time being – uncertainty remains over the treatment of Subscriber Misrepresentation Claims. Whilst both decisions confirm the admissibility of such claims, the consequence of

the *DLIFF* decision (if followed) is that there would be a significant difference between the positions of subscribing investors who rescinded their membership contract prior to a liquidation and those who did not.

This difference could have a material impact on the economic interests of unsecured creditors and redemption creditors, whose claims could be diluted or subordinated respectively. The good news is that any uncertainty should be resolved fairly soon: the appeal from the *HQP* decision is due to be heard in May 2024, and it is hoped that the Court of Appeal will be able to deliver its decision this year.

In the interim, officeholders and stakeholders in existing liquidation proceedings are likely to await the outcome of the HQP appeal proceedings. However, shareholders in companies that are not in liquidation who believe that their subscriptions might have been obtained by misrepresentation should take prompt advice on the question of rescission, as the onset of liquidation might prejudice their position significantly if they have not rescinded. Conversely, creditors of financially-distressed companies who have grounds for believing that rescission might be available to subscribing investors may wish to factor in the potential for dilution of their claims (or subordination, in the case of redemption creditor claims) by misled investors who rescind prior to the onset of liquidation.

Collas Crill acts for the Joint Official Liquidators of DLIFF.

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[1] Re Direct Lending Feeder Fund, Ltd (in official liquidation) (Unreported, Justice Segal, 13 March 2024, Cause No: FSD 108 of 2019 (NSJ))

[2] Re HQP Corporation Ltd (in official liquidation) (Unreported, Justice Doyle, 7 July 2023, Cause No: FSD 190 of 2021 (DDJ))

[3] *(1880) 5 App Cas 317*

[4] *HQP* at [166]

[5] *HQP* at [199]

[6] *[2007] 3 LRC 462*

[7] [1998] AC 298 at 325G

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

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