IN THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION

CAUSE NO FSD 108 of 2019 (NSJ)

IN THE MATTER OF THE COMPANIES ACT (2022 REVISION)

AND IN THE MATTER OF DIRECT LENDING INCOME FEEDER FUND, LTD. (IN OFFICIAL LIQUIDATION)

Before:	**The Hon. Mr Justice Segal**
Appearances:	**Richard Millett KC with Simon Dickson, Jessica Vickers, Laura Stone and David Ramsaran of Mourant Ozannes (Cayman) LLP for Eiffel eCapital US Fund** **Tom Smith KC with Mathew Dors and Rupert Stanning of Collas Crill for the JOLs**
Heard:	**25-26 May 2023**
Invitation to provide further submissions:	**10 July 2023**
Draft judgment circulated:	**29 February 2024**
Judgment delivered:	**13 March 2024**

HEADNOTE

Whether original holders of redeemable preference shares who claim damages for deceit but who are unable to rescind their subscription agreements are entitled to prove in the winding up and if they are the ranking in the winding up of such claims and the comparative ranking claims by holders of redeemable preference shares who completed the redemption process before the winding up or who have rights to prove in the winding up under section 37(7) of the Companies Act – the basis for the decision of the House of Lords in Houldsworth and of

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subsequent English cases including Soden v British & Commonwealth and whether the common law rule derived from these cases is or should be good law in the Cayman Islands – the capital maintenance rule in Cayman company law

JUDGMENT

Introduction

1. This judgment deals with a significant point of principle and authority in Cayman Islands' insolvency law, namely whether a shareholder who was induced to subscribe for their shares by a misrepresentation made by or on behalf of the company can after the commencement of the company's winding up rescind their subscription contract and prove for damages in competition with non-shareholder creditors and ahead of other shareholders' rights to a distribution. In order to determine this point it is necessary, *inter alia*, to consider what was decided by the House of Lords in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 (***Houldsworth***), what proposition of law that case and the cases that followed or referred to it stand for and whether *Houldsworth* and that proposition of law is good law, and should continue to be applied, in this jurisdiction.

2. The background to the applications with which this judgment deals are set out in my judgment dated 10 November 2022 (the ***Judgment***). The joint official liquidators (***JOLs***) of Direct Lending Income Feeder Fund, Ltd (in official liquidation) (***DLIFF***) had applied (by summons) for directions concerning various matters. First, the treatment in the liquidation of (and the exercise of their powers as official liquidators in relation to) claims made or to be made by investors against DLIFF based upon alleged misrepresentations by DLIFF in connection with the investors' subscription for their shares. Secondly, the treatment of claims by investors who had sought unsuccessfully to redeem their shares in DLIFF with effective redemption dates prior to 8 February 2019 (the ***Redemption Claims***). The tenth affidavit of Christopher Johnson (***Johnson 10***), one of the JOLs, set out the background and gave details of the investors (see [20.2]).

3. Following the filing of a further summons by Eiffel eCapital US Fund (***Eiffel***) a hearing was held to determine the appropriate procedural directions to be given to allow the Court

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to adjudicate on the JOLs' application for directions. The Judgment and the order made to give effect to it set out the directions which I gave for this purpose and provided for a hearing to be listed at which:

(a). the JOLs would advocate for the grant of the following orders (the ***Misrepresentation Orders***):

(i) an order that the JOLs be directed to exercise their function of adjudicating claims on the basis that any claims from investors of DLIFF based upon asserted misrepresentations by DLIFF in relation to their subscriptions for shares in DLIFF were not barred as a matter of law solely due to the fact that DLIFF was in liquidation; and

(ii) an order that, in the event that any claims from investors of DLIFF based upon asserted misrepresentations by DLIFF in relation to their subscriptions for shares in 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.

(b). Eiffel would advocate against the grant of the Misrepresentation Orders. Eiffel, Prêtons Ensemble 2 and Eiffel eCapital Global Fund (the ***Eiffel Funds***) were shareholders of DLIFF who gave notice to redeem their shareholding on 21 November 2018 but who had not been paid the redemption proceeds (parties in the position of the Eiffel Funds have been referred to as ***Late Redeemers***). The Eiffel Funds have filed proofs of debt in the liquidation (on 27 September 2019) but the JOLs have not yet adjudicated the proofs.

4. The hearing (the ***Hearing***) took place on 25 and 26 May 2023. At the Hearing, Richard Millett KC appeared for Eiffel and Tom Smith KC appeared for the JOLs.

5. Shortly before the Hearing, upon receipt of the parties' skeleton arguments, I found out that the same issue arising on the JOLs' summons had been raised and was to be dealt with by Mr Justice Doyle in another liquidation and proceeding in this Court. This is the official liquidation of HQP Corporation (***HQP***). A hearing before Justice Doyle had been

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listed on 17 and 18 May 2023, very shortly in advance of the Hearing. At the Hearing, I raised this issue with Mr Millett KC and Mr Smith KC (both of whom were counsel in *HQP* and had appeared before Justice Doyle). I noted that in my view it would have been more cost-effective for the common issue of principle arising in both liquidations (even if the underlying facts were different) to have been listed before one Grand Court Judge (or at least for that possibility to have been raised with the Court in advance of the listing of two separate hearings). That would have avoided a duplication of expense and effort and the risk of inconsistent judgments. I was told that consideration had been given to this approach but that the liquidation committees wished there to be a separate adjudication of the issue in each liquidation. I said that in the circumstances, since the hearing before Justice Doyle had now taken place and all parties in these proceedings were ready and wished to go ahead, it seemed to me that the best way to proceed was for me to hear the parties' submissions but then to wait until Mr Justice Doyle had handed down his decision before finalising and deciding what approach to take in my judgment. Mr Millett KC and Mr Smith KC were content with this although they both requested that I consider the issues raised and prepare a separate judgment since, they submitted, the arguments before me had developed differently from the arguments presented to Mr Justice Doyle and the context in which the issues arose in DLIFF's liquidation was different from that of HQP.

6. Mr Justice Doyle (with his usual promptness and efficiency) delivered his judgment on 7 July 2023 (***Justice Doyle's Judgment***) and I received a copy of the decision shortly thereafter. At that point, I asked the parties whether they wished to have the opportunity to make further submissions based on and by reference to Justice Doyle's Judgment, but they declined the invitation as they considered further submissions to be unnecessary.

7. I have now had an opportunity to study Mr Justice Doyle's elegant and clearly reasoned judgment (unfortunately because of the summer break shortly after the handing down of Justice Doyle's Judgment and a number of other heavy cases that I have had to deal with it has taken me some time to finalise this judgment). I am aware that Mr Justice Doyle has granted permission to appeal and therefore, that the issues he has dealt with and which arise in this case will be considered by the Court of Appeal. I considered whether the right approach was simply to follow his reasoning and decisions and then to leave it to the Court of Appeal to decide whether to affirm Mr Justice Doyle's ruling. I must confess

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to finding this an appealing option (no pun intended) but in view of the firm request not to do so made by Mr Millett KC and Mr Smith KC and since, as will become apparent, I take a different view from Mr Justice Doyle on the key issues arising, I concluded that I should set out my own analysis and decisions.

The core issues and the parties' submissions in outline

8. In deciding whether to make the Misrepresentation Orders it is necessary to determine whether claims for unliquidated damages for misrepresentation made by members who were induced to subscribe for their shares by DLIFF's misrepresentations (***Misrepresentation Claimants***) are entitled to be admitted to proof in DLIFF's liquidation at all (the ***Proof Point***) and then if such claims are admissible where they rank in the order of priorities in the liquidation (the ***Priority Point***), in particular whether they rank (a) in priority to Redemption Claims (by investors such as the Eiffel Funds) (b) *pari passu* with Redemption Claims or (c) subordinate to such Redemption Claims.

9. Eiffel contends that:

(a). the Misrepresentation Claimants' claims are barred from admission to proof by the principle of law (the ***Houldsworth Principle***) established by the House of Lords in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 (***Houldsworth***) and the subsequent cases that have explained and followed it. This Court should follow and apply that principle.

(b). if, contrary to Eiffel's primary contention, the Misrepresentation Claimants' claims are admissible and admitted to proof then nonetheless Eiffel's claims (and all Redemption Claims) rank in priority to the Misrepresentation Claimants' claims and are neither *pari passu* with nor subordinate to them.

(c). the question of admissibility and ranking are to some extent linked not only because many of the relevant authorities examine both questions together but also because the issue of admissibility becomes less significant if the Misrepresentation Claimants' claims are treated as subordinated to Redemption Claims. Eiffel argued that if the Court declined to apply the Houldsworth Principle then unless

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misrepresentation creditors were subordinated to creditors with claims for payment of redemption monies (such as Eiffel) or to redeeming shareholders who had become creditors by having given notice of redemption, the order of liquidation priorities would be disturbed because the Court would be permitting shareholders (the Misrepresentation Claimants) improperly to elevate themselves to the status of creditors. This would potentially have a damaging impact on the Cayman Islands as an investment centre (and indeed more generally) and raised policy issues that were best considered by and left for decision by the legislature and not the Court.

10. The JOLs contend that:

(a). even though those Misrepresentation Claimants who had failed to exercise the right to rescind their subscription agreements (or membership contract) before the commencement of DLIFF's winding up had lost the right to rescind (and it was assumed for the purpose of this application that none of the Misrepresentation Claimants had exercised their right to rescind prior to the commencement of the liquidation) and were therefore now unable to claim damages under section 14(2) of the Contracts Act (1996 Revision) (the ***Contracts Act***) (which gives the Court the power to declare the contract subsisting and award damages in lieu of rescission), nonetheless they remained entitled to claim both damages arising from fraudulent misrepresentation and statutory damages under section 14(1) of the Contracts Act (which creates a statutory claim for innocent misrepresentation subject to the defence set out in the sub-section). In the case of these causes of action the remedies of rescission and damages were not alternative but cumulative and the availability of rescission was not a condition for such damages claims as it was for claims under section 14(2).

(b). such misrepresentation claims (the ***Misrepresentation Claims***) are provable. Section 139(1) of the Companies Act establishes what debts and claims of creditors are admissible to proof. The Misrepresentation Claims are covered by and come within that sub-section. Section 140(1) of the Companies Act establishes the rights of creditors to be paid and of members to receive a distribution out of the assets of the company in liquidation. The Misrepresentation Claims are covered by, and the Misrepresentation Claimants are entitled to rely on, that sub-section. There was no

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statutory prohibition against the admission of claims from members whether in their character as members or otherwise.

(c). the Misrepresentation Claims are also not barred by any principle established by *Houldsworth* or the cases that followed it, even if it is considered to form part of the law of the Cayman Islands. The Houldsworth Principle, properly understood, could be summarised as follows. Where a shareholder contracts to contribute to a company a certain amount to be applied in payment of the debts and liabilities of the company then it was inconsistent with his position as a shareholder, while he remained a shareholder, to claim back any of that sum. That principle however was not engaged in the present case because (i) none of the investors in DLIFF were under any liability to DLIFF to contribute funds to the winding up (all of the shares were issued as fully paid up and there was no question of the JOLs making any calls on any shareholder); (ii) the Misrepresentation Claimants would be seeking neither to avoid obligations under the statutory contract nor a return of share capital but simply damages (the measure of which would be contingent, *inter alia,* upon subscription monies, the value of the shares at acquisition and potentially disposition, loss of profits and benefits); (iii) there was therefore no inconsistency between the relevant investors making Misrepresentation Claims and any obligation on their part to contribute funds to DLIFF to pay its debts and liabilities. The Misrepresentation Claims did not involve the Misrepresentation Claimants seeking to claim back money which they had agreed to contribute to pay the debts and liabilities of DLIFF.

(d). while section 49 of the Companies Act provides for the subordination (but not the preclusion) of claims by members in their character as such, the Misrepresentation Claims are not made by the relevant investors in their capacity as shareholders in DLIFF.

11. My conclusions on the Proof Point can be summarised as follows:

(a). I consider that in the absence of any binding authority in this jurisdiction and in view of the dispute concerning the meaning and effect of the English cases starting with and following *Houldsworth*, the proper approach is to determine the legal

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position under English law and then consider whether the law as so formulated applied or should be applied in this jurisdiction.

(b). there is no dispute (and I must therefore assume) that the Misrepresentation Claimants lost the right to rescind their subscription agreements on the commencement of DLIFF's winding up (although I consider that the issue of whether the right to rescind is permanently lost or is only barred to the extent that the exercise of the right would prejudice third party creditors may need further consideration by a higher Court).

(c). there was, before the legislative intervention in 1989, a common law rule (which I have referred to below as the "no-proof proposition") in England to the effect that where a shareholder was not entitled to rescind his/her subscription contract after the commencement of the winding up (and it was established by authority that the right to rescind terminated on winding up), the shareholder was not entitled to prove in a winding up for damages for misrepresentation (which induced him/her to enter the subscription contract). But in my view, the rule, properly understood, only precluded such a shareholder from proving in competition with external (non-shareholder) creditors and did not give rise to an absolute bar on proof even after non-member creditors had been paid in full (or were suitably provided for).

(d). that common law rule operated alongside the statutory regime governing the right to prove in a winding up. The English statutory code governing the winding up of companies was (and is) not considered to be complete and was (and is) subject to some long-established judge made (common law) rules including the no-proof proposition.

(e). since the relevant statutory code and the common law rules (as set out in the case law) governing winding up and capital maintenance in this jurisdiction are based on and are broadly similar (albeit not identical) to the related statutory regime and common law rules in England, the starting point is the law in England and the related principles and legal reasoning which apply in this jurisdiction, so that the no-proof proposition should be treated as good law in the Cayman Islands unless there is a proper reason which justifies adopting a different common law rule.

(f). the JOLs argued that (if they were wrong about the proper interpretation of English law, which in my view they were) there were a number of strong reasons for treating the law of the Cayman Islands as different from England and for recognising or adopting a different common law rule here. In particular, they said that: (i) the case law in other jurisdictions, particularly in Australia and Bermuda, demonstrated that the no-proof proposition was unsound and could not be justified as a matter of law; (ii) the fact that other jurisdictions had changed the law by legislation demonstrated that the English common law rule was outdated and damaging; and (iii) that local conditions required a different approach (in particular the need to protect and promote the important and large investment funds industry which depended on the use of companies issuing redeemable shares as open-ended investment funds) and that the amendments made to the companies legislation in this jurisdiction (in particular the provisions in the Companies Act which liberalise our capital maintenance rules as they apply to redeemable shares and the use of the share premium account to make payments due on the redemption of the shares without the need to satisfy the statutory solvency test) reflected careful policy choices (to support investment funds by promoting and protecting the interests of investors in those funds, even if this was at the expense of creditors) which would be undermined by following the approach under English law.

(g). in my view, while it is clear that there are now material differences between the companies law in this jurisdiction and in England (and I accept that the capital maintenance rules here have been liberalised and are different from those in England in some material respects) and while I also accept the great importance and significance for this jurisdiction of the investment funds industry and the need to establish a legal framework and conditions that are conducive to the effective operation of the investment funds' business model, I do not consider that these factors justify the conclusion that the no-proof proposition has been and should remain a common law rule in this jurisdiction. Having said that, if I am wrong as to the proper analysis of the English cases so that the English law rule established an absolute bar on the admission of claims for damages in deceit by original holders of redeemable shares, I would refuse to apply the rule in those terms and apply it in the qualified form that I have formulated and described.

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(h). the JOLs' arguments, in my view, are overstated and in some cases unsupported by relevant and probative evidence. The amendments to the capital maintenance rules as they relate to payments out of the share premium account on redemption do not apply to claims for damages in deceit and, in any event, must be considered alongside the statutory regime governing the right to prove and ranking of shareholders who exercised their right to redeem before the winding up. It seems to me that it would be inconsistent with that regime for original holders of redeemable shares with claims for damages in deceit to be able to prove and rank ahead of non-member creditors when such redemption creditors cannot do so. I also do not regard the reasoning in the Australian and Bermudian cases as undermining the reasoning that supports and justifies the no-proof proposition. Finally, and significantly, the JOLs have not adduced any evidence to show that the retention or adoption of the no-proof proposition (as I have formulated it) would have any, let alone a significant adverse effect, on our investment funds industry.

(i). I have carefully considered Justice Doyle's Judgment and while I have found his reasoning to be cogent and while I would usually follow his approach, on this occasion it seems to me that different reasoning and a different conclusion are required and justified. This can be explained, I think, because we are dealing with authorities that have been widely referred to as opaque and recognised as cases whose reasoning is notoriously difficult to discern and pin down.

12. My conclusions on the Priority Point can be summarised as follows:

(a). I have, as already noted, held that the Misrepresentation Claims are not provable in competition with the claims of non-member creditors but are provable once those external creditors have been paid (or fully and properly provided for). This ranking is the result of both the no-proof proposition and section 49(g) of the Companies Act. In my view, the Misrepresentation Claims are subject to section 49(g) since they are "*due to [a] member of a company in that person's character of a member by way of dividends, profits or otherwise*." As a result they are not "*deemed to be a debt of the company, payable in… competition [with] …any other creditor not being a member of the company*." I consider that the reasoning of Lord Browne-

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Wilkinson in *Soden v British & Commonwealth Holdings plc* [1998] AC 298 is sound and represents the law in this jurisdiction and, furthermore, is to be preferred to that of the majority of Justices in the High Court of Australia in *Sons of Gwalia Ltd v Margaretic* [2007] 3 LRC 462.

(b). the claims of holders of redeemable preference shares who gave notice of and completed the process of redemption before the winding up (redemption creditors) are also subject to section 49(g). The claims of members subject to section 49(g) rank *pari passu*. Accordingly, the claims of Misrepresentation Claimants and of the redemption creditors are provable after the non-member creditors have been paid (or provided for) and then rank equally.

(c). while there appear to be no holders of redeemable shares who had failed to give notice to redeem and complete the redemption process before the winding up but who have rights under section 37(7)(a) of the Companies Act, so that the question of their ranking as against shareholders with claims subject to section 49(g) does not arise for decision, I consider it likely that the shareholders with rights under section 37(7)(a) are to rank, after payment of the non-member creditors, *pari passu* with the shareholders with claims subject to section 49(g). This is because the Companies Act establishes a parallel subordination and therefore similar ranking for both classes of claimant without stipulating that one class ranks ahead of the other and because giving shareholders with rights under section 37(7)(a) equal ranking with redemption creditors can be seen as giving effect to the policy of protecting the position of holders of a limited class of redeemable shareholders who can be seen as deserving equal treatment with redemption creditors because they must show that their terms of redemption provided for redemption before, and that the company could have lawfully paid the sums due on redemption in the period up to the start of, the winding up.

(d). once again I have, reluctantly, found myself unable to adopt Justice Doyle's reasoning and follow his conclusion on this issue. My explanation for my different conclusion is set out below.

Background

13. DLIFF is part of a master/feeder fund structure in which it is the offshore feeder fund. DLIFF and its onshore counterpart, Direct Lending Income Fund, L.P. (***DLIF***, together with DLIFF, the ***Feeder Funds***) sought subscriptions and invested in DLI Capital Inc. (the ***Master Fund***). DLIFF was established in 2016 as part of a group restructuring in order to act as the offshore feeder fund for the DLI Group. A number of (non-U.S.) investors of DLIF redeemed their investments in DLIF in late 2016 and re-invested in DLIFF. DLIFF then continued to seek subscriptions from non-U.S. investors until the suspension of subscriptions in February 2019.

14. Investors invested in DLIFF by subscribing for redeemable shares in various series initially at an offering price of $1,000 per share and thereafter at the prevailing Net Asset Value (***NAV***) per share for the relevant series. The shares had a nominal value of US$0.01 each, whereas the prevailing NAV per share (over the trading lifetime of DLIFF) was in the region of $1,000 to $1,200, meaning that the vast majority of each subscription was premium. Under the terms of DLIFF's articles, such premium was to be credited to the share premium account (see article 36).

15. The DLI Group encountered liquidity difficulties in late 2018 and in particular had suffered losses in respect of an investment into a company called VoIP Guardian LLC. The last net asset value struck in respect of DLIFF was for the valuation day of 30 November 2018 and was approximately US$180 million. However, a number of redemption and subscription requests were made for effective dates between 1 December 2018 and DLIFF's suspension of subscriptions and redemptions on 8 February 2019 (the ***Suspension Date***). Following the suspension, and the filing of a complaint by the SEC on 22 March 2019, DLIFF together with the rest of the DLI Group was placed in receivership on 1 April 2019 pursuant to an order of the U.S. District Court for the Central District of California and Mr Bradley Sharp was appointed as receiver.

16. Mr Sharp, having obtained approval from the District Court, proceeded to exercise the rights of DLIFF's managing shareholder to place DLIFF into voluntary liquidation in this jurisdiction by passing a special resolution on 14 May 2019. Mr Sharp and Mr

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Christopher Johnson were appointed as joint voluntary liquidators (***JVLs***). On 18 June 2018, Mr Sharp and Mr Johnson (as JVLs) applied by way of petition for the liquidation of DLIFF to continue under the supervision of the Court and on 25 July 2019, the Court made an order to that effect (that Mr Sharp and Mr Johnson be appointed as the joint official liquidators).

17. Over the course of its trading life (from October 2016 to February 2019), DLIFF accepted approximately US$287.7m in subscriptions and paid out approximately US$128.3m in redemptions and monthly distributions (leaving a balance of US$159.4).

18. The subscriptions included cash paid by investors in respect of first-time subscriptions for shares in DLIFF with subscription dates of 1 January 2019 or 1 February 2019 (the ***New Late Subscribers***) and cash paid by investors who had previously invested in DLIFF but then paid cash to DLIFF in respect of further subscriptions for shares in DLIFF with subscription dates of 1 January 2019 or 1 February 2019 (the ***Pre-Existing Late Subscribers***, together with the New Late Subscribers, the ***Late Subscribers***).

19. The redemptions paid out included redemptions by investors who were fully redeemed prior to December 2018 (who therefore in effect withdrew from the fund with an aggregate of US$4.7m net profit). DLIFF's net investment value by reference to the remaining investors (but excluding redemption requests effective after 30 November 2018) was therefore approximately US$164.1m. As noted above, DLIFF's last stated NAV (for 30 November 2018) was approximately US$180m. However, the JOLs believe that the NAV was materially mis-stated for much, if not all, of the life of DLIFF. For that reason, the JOLs consider it more appropriate to refer to and calculate investment value by reference to net investment.

20. The stakeholders of DLIFF can be most conveniently categorised as follows:

    (a). unsecured, third-party creditors who were not investors of DLIFF, such as former service providers (the ***Trade Creditors***).

    (b). DLIFF's current investors (each an ***Investor*** and together the ***Investors***), comprise the following sub-groups (these groups are not mutually exclusive so that an

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Investor could be, for example, a Late Subscriber in respect of part of its investment and an Unredeemed Investor in respect of the remainder and since certain of the Late Redeemers only sought to redeem part of their shareholding in DLIFF with effective redemption dates prior to the Suspension Date then at least with respect to part of their investments they are also categorised as Unredeemed Investors):

(i). those Investors who sought to redeem their shareholding in DLIFF with effective redemption dates prior to the suspension of withdrawals and voluntary redemptions on the Suspension Date but who remain unpaid (the ***Late Redeemers***).

(ii). those Investors who made payments to DLIFF on 1 January 2019 or 1 February 2019 in respect of either initial or additional subscriptions for shares in DLIFF with subscription dates on those days (the ***Late Subscribers***). The sums paid by the Late Subscribers was approximately US$10.8 million.

(iii). those Investors not falling into the above two categories (the ***Unredeemed Investors***). The net value of their investments totals approximately US$125.5 million.

21. The Trade Creditors are relatively small in number and amount and the JOLs say that there is no chance of a sufficient number of claims from the other stakeholders ranking *pari passu* with the Trade Creditors to prevent them being paid in full. They will therefore be paid in full in any event. There were also some investors of DLIFF who withdrew all their funds invested in DLIFF prior to the Suspension Date (the ***Former Investors***). Ignoring the possibility that the Former Investors (as ultimate beneficial owners of the shares) might have reinvested in DLIFF after such redemption via a different nominee, they have no economic interest in the distribution of DLIFF's assets.

22. The JOLs consider that it is at least reasonably arguable that Investors holding at least 75% of the existing issued shares (by net investment value) in DLIFF have *prima facie* claims for damages for misrepresentation against DLIFF.

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23. The JOLs estimate that DLIFF will receive total distributions from the Master Fund of approximately $80 million. The JOLs have received proofs of debt from the Trade Creditors in the amount of $19,649, claims in respect of unpaid redemptions totalling approximately $33 million based on the November 30, 2018 NAV, and claims from the Late Subscribers of approximately $11 million. Accordingly, the JOLs have to date determined the liquidation to be solvent. However, once liquidation expenses are settled, there is unlikely to be more than 50% of the net cash invested by Investors available for distribution. Accordingly, the relative priority of the Investors' claims *inter se* (including in relation to the claims of the Misrepresentation Claimants) is likely to be of critical importance in determining who receives distributions out of the proceeds of the realisation of DLIFF’s assets.

The basis of the claims made by the Misrepresentation Claimants

24. The JOLs say that in the event that claims based on misrepresentation are asserted by the Misrepresentation Claimants, each such claim can be expected to comprise a claim for damages based upon the principle that the claimant is entitled to be put in the position he would have been in if no false representation had been made (insofar as money can do it). In these circumstances, such a claim for damages can be expected to include (a) the difference between the subscription price paid and the value of the shares, (b) losses in value after purchase but prior to disposition (or, in a liquidation context, distribution), (c) loss of profits that would otherwise have been earned with the subscription monies and (d) a credit in respect of any benefits (i.e. dividends) received as a result of the subscription.

25. The JOLs also say that if claims based on misrepresentation are both available as a matter of law and payable in priority to the return of capital to Investors (whether ahead of or *pari passu* with the debts of unsecured creditors or subordinated debts), this would have a significant impact on distributions in the liquidation. Those Investors who are able to establish claims based upon misrepresentation would be entitled to be paid ahead of those who are not able to establish either Misrepresentation Claims or other claims such as those asserted by the Late Subscribers and Late Redeemers. Additionally, it is possible that the Misrepresentation Claims would significantly dilute the claims of the Late

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Subscribers (if admitted), and subordinate the claims of the Late Redeemers (if admitted) such that they could be rendered valueless.

Eiffel's position

26. The Eiffel Funds are former holders of redeemable shares. On 21 November 2018, the Eiffel Funds issued redemption requests for all their shares and on the same day DLIFF's investment manager (Direct Lending Investments LLC) (the ***Manager***) confirmed receipt and said that the redemption requests would be processed "*with a 12/31/18 effective date*." Pursuant to article 8.8 of DLIFF's articles, the redemption date was therefore 31 December 2018. On that date, the Eiffel Funds (including Eiffel) ceased to be shareholders and became creditors of DLIFF for the redemption price. That was confirmed by letter from the Manager dated 11 February 2019, which also confirmed that the redemption price was payable in priority to other payments or distributions to DLIFF's equity-holders. On 11 February 2019, the Manager notified the Eiffel Funds that, effective 8 February 2019, DLIFF had suspended investor's rights to redeem or withdraw their investments and to be paid outstanding redemption payments. Consequently, the Eiffel Funds were not paid the redemption proceeds then due. They are Late Redeemers. On 27 September 2019, each of the Eiffel Funds filed proofs for their unpaid redemption proceeds plus interest in the total sum of US$27.4 million. Eiffel's proof of debt is for US$12,589,611.81.

The Proof Point - Eiffel's submissions

Eiffel's primary case

27. As I have noted, Eiffel's primary case is that the Misrepresentation Claimants' claims are barred from admission to proof by the principle established by the House of Lords in *Houldsworth* and the subsequent cases that followed and explained that this Court should apply that principle.

28. Eiffel submitted that *Houldsworth* as interpreted by subsequent English authority stood as and was authority for the proposition that shareholders with misrepresentation claims were not entitled after the commencement of a winding up to rescind their subscription

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contracts and prove in the winding up for damages. This proposition remained good law and was sound in principle. The basic rationale for this proposition of law (and therefore for the Houldsworth Principle) was that after a winding up, when a company's capital was to be fully available to meet all its debts and liabilities to creditors (or members with statutory priority), a subscriber for shares could not remove from the company the economic benefit of his/her original contribution to its capital. He/she could not rescind their contract of subscription, and thereby their membership, and the liabilities to contribute that go with it. He/she must retain (and to use Eiffel's phrase, he/she was stuck with) the legal and economic consequences of continuing membership. If that were not so, and he/she could be paid out the value of his original subscription, he/she would reduce the capital of the company at the very moment that the company needed it most. That, Eiffel said, would offend the most fundamental of rules of company law. What is more, the shareholder would also remain on the register and be entitled to whatever surplus might remain. The shareholder could not have it both ways.

29. Eiffel argued that it remained a common law rule that it was unlawful for a company to return capital otherwise than in a manner permitted by statute, and allowing the Misrepresentation Claims to be proved in a winding up would involve such a return of capital. A return of capital (including making payments to shareholders which in substance amounted to a return of capital) was precluded by the common-law rule in *Trevor v Whitworth* (1887) 12 App Cas 409 (that a company has no power to purchase its own shares unless permitted by statute). Eiffel accepted that the rules governing the return of capital were now almost entirely statutory but argued that statute did not cover the whole territory. *Trevor v Whitworth* remained good law and stood as a foundational principle. Eiffel submitted that it would be wrong to erode the statutory control of and restrictions imposed on returns of capital by creating a new category of shareholder claim and right pursuant to which capital could in substance be returned to shareholders while they remained shareholders and retained their shares.

30. Eiffel said that the widespread reference to the "principle in *Houldsworth*" was misleading. The principle or proposition of the common law on which Eiffel relied had been developed and been articulated in a line of cases of which *Houldsworth* was arguably the most significant but the basis of and the scope of the common law principle was not limited to the facts of or by the formulation of the principle

expressed in *Houldsworth* (it was, Eiffel said, not confined to the four corners of that decision). That was why, Eiffel submitted, the exercise of seeking to distinguish *Houldsworth* or to confine it to its particular facts was only attractive from a forensic perspective. By the turn of the twentieth century, *Houldsworth* had come to stand for a wider principle than the case itself decides. But the cases, when taken together, established a very clear principle or common law rule (the use of the term "the rule in *Foss v. Harbottle"* was analogous).

31. Eiffel accepted that there was no decision binding on this Court which required the Court to follow the ratio of *Houldsworth* (as properly understood) and the English (or other common law jurisdiction) cases applying and explaining (or reformulating) it but Eiffel argued that since the Houldsworth Principle as Eiffel formulated it was entirely consistent with Cayman company and insolvency law and since the established practice of this Court was generally to apply the English common law, the Court should give effect to the Houldsworth Principle in this case and generally. The exceptions to the practice of following the English common law related to cases where the relevant English common law rule had been overruled, was inconsistent with Cayman Islands legislation, or where the Court had developed the common law in Cayman in a materially different way. These exceptions did not apply to the Houldsworth Principle and in this case. Furthermore, Eiffel noted that the Judicial Committee of the Privy Council was not bound by the English common law (or decisions of the House of Lords or Supreme Court) where local conditions required that a different approach be taken to the common law as applied in a particular jurisdiction or even to a similar statutory provision, but once again Eiffel submitted that there were no local conditions that made it inappropriate for the common law rule established by the *Houldsworth* line of cases to be applied in this jurisdiction. Eiffel said that it was significant that the former Chief Justice (Sir Anthony Smellie) had in one case (discussed below) considered it to be "*obvious*" that misrepresentation claims could not be admitted to proof in a winding up on the basis of "*the longstanding authority of Houldsworth.*"

The proposition of law for which Houldsworth stands as authority

32. Eiffel noted that in *Houldsworth* the claimant had in February 1877 subscribed for and bought £4,000 of shares in the defendant bank. The bank went into insolvent liquidation

in October 1878, and in December 1878 the claimant brought proceedings against the bank and its liquidators for fraudulent misrepresentations made by the bank's directors which had induced him to subscribe for the shares. He claimed by way of damages the amount of his subscription monies. The House of Lords dismissed his appeal on the basis that since, on the winding up, he had lost his right to rescind, he could not thereafter maintain an action for damages against the company for fraudulent misrepresentation.

33. Eiffel submitted that the principle (or proposition) of law for which *Houldsworth* should now be treated as authority (put at its simplest) was that after a winding up order is made a member cannot claim against the company, and prove for, damages for misrepresentation made by the company which induced him to subscribe for his shares which he still holds.

34. Eiffel argued that this principle or proposition derived from the related principle, established by the House of Lords in *Oakes v Turquand* (1867) LR 2 HL 325 (***Oakes***) and *Tennent v City of Glasgow Bank* (1879) 4 App Cas 615 (***Tennent***), that once a winding up had supervened it was not possible to rescind a contract of subscription for shares on the grounds of fraudulent misrepresentation. Both of those earlier decisions of the House of Lords were affirmed in *Houldsworth*.

35. Eiffel accepted that the precise formulation of the *ratio* of *Houldsworth* and of the proposition of law for which the decision was to stand as authority were contested and debated in a number of decisions (in various jurisdictions) and by textbook writers and commentators. Eiffel submitted that nonetheless the rationale which emerged from the speeches in *Houldsworth* was that after a winding up a shareholder could not both retain his shares and claim damages from the company for the value of his investment where the damages would in economic terms involve or equate to a return of capital. That is, he cannot approbate and reprobate. He cannot take inconsistent positions by both claiming to remain a shareholder and seeking to recover the economic or financial value of his shares and investment.

36. In the later decision of the English Court of Appeal in *Re Addlestone Linoleum Co* (1887) 37 Ch D 191 (***Addlestone***), Lindley LJ had explained the decision in *Houldsworth* (at pages 205-206) as follows:

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> "*The principle on which the House of Lords decided [Houldsworth] was that a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that it is inconsistent with his position as shareholder, while he remains such, to claim back any of that money – he must not directly or indirectly receive back any part of it*."

37. That rationale, Eiffel submitted, could be understood in terms of the common law prohibition on the unauthorised return of capital, which was in development at the time. The cases articulating this principle culminated in two decisions of the House of Lords in *Trevor v Whitworth* and *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (***Ooregum***). In *Webb Distributors (Aust) Pty Ltd v State of Victoria* [1993] 4 LRC 395 (***Webb***), Mason CJ, giving the lead judgment of the High Court of Australia, had correctly identified the link between the principle in *Houldsworth* and the principle in *Trevor v Whitworth* and *Ooregum*.

38. This approach, Eiffel said, had been clearly set out at the Court of Appeal level in the decision upheld by the High Court in *Webb*. Eiffel relied on the reasoning of Justice Tadgell (who gave the leading judgment with which Justices Fullagar and Gobbo agreed) in the Appeal Division of the Supreme Court of Victoria in *State of Victoria v Hodgson and others* [1992] 2 V.R. 613. Eiffel relied on various passages in Justice Tadgell's judgment, and I set them out in full below since Eiffel's case closely follows Justice Tadgell's reasoning (underlining and emphasis added):

> *[page 617] "The central issue seems to be this: whether a person who has subscribed share capital, and would in a winding up rank for repayment of capital behind unsecured creditors, may, instead of being left to his rights as a contributory, prove as an unsecured creditor for an unliquidated sum if he can make out a cause of action sounding in damages designed to compensate him for having subscribed the share capital..... That formulation of the issue is reminiscent of the question posed for resolution by Earl Cairns [Lord Chancellor] in Houldsworth ... The House of Lords answered the question No. The company there in question, the City of Glasgow Bank, was an unlimited company in liquidation. Rescission of the contract to take shares was not sought or available and the shareholder was left with his liability upon his shares, which was held to be inconsistent with a right to claim damages against the company and its liquidator. Later commentators have not been altogether agreed on the ratio decidendi of the case or its scope. ...*
>
> *[pages 626 to 628] There are several bases on which the conclusion in Houldsworth's Case appears to be founded. One is that, to allow a present*

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*shareholder to sue the company would in effect involve his making a claim against himself along with his fellow members. This seems to have influenced Lord Hatherley: at p. 333. Insofar as it did so this basis would seem to justify part of Professor Gower's criticism ... it could scarcely survive Salomon v. Salomon & Co. Ltd. .... The appellant, however, did not rely on this basis. Lord Hatherley also referred to the prospect, if a claim for damages by a person in the position of the appellant were allowed, of a series of interlacing claims for damages by several members, leading to endless calls. Anderson J. in Re Dividend Fund Incorporated, at p. 454, referred to this as 'something akin to perpetual motion', and as tending to suggest that the claim should not be countenanced. The point is relevant, if at all, only when the claim is made against an unlimited company, which is not this case. **Another basis for the conclusion in Houldsworth's Case is that the allowance of a claim for damages by a member against a company of which he is a member would be inconsistent with implied terms of the contract by which the member became a member, in that the claim would entrench on share capital to the detriment of creditors and other members. Even Professor Gower seems to have conceded that the decision might be justified on that ground**: The Principles of Modern Company Law 2nd ed., 1957 p. 295; and it is a ground on which the Solicitor-General relied for the appellant. It derives support from the speeches in Houldsworth's Case of Lord Cairns, at p. 325, and Lord Selborne, at p. 329, whose remarks suggest the thesis that one of the implied terms of the contract of membership is that the company's property is to be used only for the purpose of achieving its objects, which do not include the payment of compensation to defrauded subscribers: cf. Pennington. Vincent J. was evidently unimpressed with the thesis: his response was that it 'borders on the bizarre'. Another response may be that, given that a member may rescind his contract to take shares at any time during the life of the company, it is nothing to the point to say that creditors and fellow members would be disadvantaged by a claim for damages: Ford, p 298.*

There was a concession in the course of argument in Houldsworth's Case that, if a shareholder at the commencement of the winding up could validly raise a claim for damages of the kind sought against the company and its liquidator after the commencement of the winding up, he must also have had a right before the winding up to have remained a shareholder and yet to maintain an action for damages against the company. Hence the form of the question posed by Lord Cairns, quoted above, which did not suppose that the company was in liquidation. Accordingly, save that the winding up precluded rescission of the contract to take shares, the burden of the reasoning of their Lordships appears not to have depended on the fact that the company was in liquidation, or particularly upon the winding up provisions of the Companies Acts.

***Whatever difficulties there may be in accepting the result in Houldsworth's Case as wholly justifiable when the company is not in liquidation, there is every justification for it in the case of a company in liquidation, including a company limited by shares**.*

In my opinion the principle of limited liability leads inevitably to the conclusion that a member at the commencement of the winding up of a company limited by shares cannot prove in the winding up for damages designed to indemnify him for loss sustained in subscribing share capital to the company. The member's

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only title to such damages would depend on his having sustained loss through a subscription of share capital. If he were to obtain indemnity from the company in respect of that loss he could not logically be regarded as having subscribed the share capital for the subscription of which the company had indemnified him.

Central to his liability is s. 360(1) of the Code. That section requires that, on the winding up of a company to which it applies, every member is liable to contribute to the property of the company in accordance with the formula it prescribes. That is an ineluctable obligation of those who are members at the commencement of the winding up, as it has been ever since the Companies Act 1862, s. 38 of which was the model for s. 360. The obligation is to contribute to an amount sufficient for payment of the company's debts and liabilities and the costs, charges and expenses of the winding up, and for the payment of such sums as may be required for the adjustment of the rights of the contributories among themselves, with the qualifications that the section sets out:.............The principle is that any claim for debt or damages that a member might mount against the company for any reason at all cannot directly or indirectly diminish the obligation to pay the monetary amount which the member is liable to contribute as a member. ***It must follow that a holder of fully-paid shares cannot diminish the amount of his already-paid contribution to the property of a company that is in liquidation by obtaining [an] indemnity from the company against loss sustained by the making of that contribution. If the member were to prove in the winding up, and receive a dividend designed to provide for such indemnity, he would remain subject to such liability as his membership involved. His contract of membership, being unrescinded, would carry with it an obligation to contribute the par value of his shares. It would not be open to him, having obtained as a dividend an amount equal to the whole or part of his contribution, to contend that in reality his shares were fully paid****."*

This conclusion does not depend on an acceptance of the whole of the reasoning in Houldsworth's Case but is indicated by much of it. It is more particularly indicated by the reasoning of Kay J. and the Court of Appeal in Re Addlestone …, which applied the more general approach in Houldsworth's Case — and in my respectful view naturally and inevitably applied it — to the case of a winding up of a company limited by shares*."*

39. Eiffel said that Lord Justice Lindley in *Addlestone* had correctly set out the true ambit of the approbation and reprobation principle. This is that a person cannot remain a shareholder and have back the capital he/she has contributed, whether by way of an offset against their liability to pay a call or by way of damages representing already invested capital. This was a principle that applied to a limited company. In essence, to repay a shareholder the value of his/her contribution to the company's capital while he/she still continued to hold their shares was a form of unlawful return of capital. After a winding up, the interests of the creditors and other members intervened and would be prejudiced if the capital were reduced.

40. Eiffel submitted that the speech of Lord Browne-Wilkinson in *Soden v British & Commonwealth Holdings plc* [1998] AC 298 (***Soden***) made clear that this was the law and the basis and scope of the applicable common law principle. *Soden* was concerned with whether a claim for damages against a company for misrepresentations which had induced a purchaser of shares to buy them on the market from an existing shareholder was subordinated by section 74(2)(f) of the UK Insolvency Act 1986. It involved an examination of both *Houldsworth*, *Addlestone* and *Webb*. Eiffel submitted that the House of Lords had had the opportunity to rule but had not decided that *Houldsworth* was either wrongly decided or ought no longer to reflect the common law. *Houldsworth* and the Houldsworth Principle were live issues not least because had the House of Lords considered that *Houldsworth* was wrongly decided or that the Houldsworth Principle was not good law, they could and would surely have said so and thereby have rendered entirely academic the key distinction relied on by Lord Browne-Wilkinson between a share purchase from the company as subscriber (to which the Houldsworth Principle was held to apply) and a share purchase from a third party (to which the Houldsworth Principle was held not to apply).

41. Eiffel submitted that on the contrary the central part of Lord Browne-Wilkinson's reasoning was based on the proper scope of the Court of Appeal's decision in *Addlestone*, which in turn was based heavily on *Houldsworth*. Although the effect of *Houldsworth* had been reversed by the UK Parliament by legislation in 1989 (section 111A of the Companies Act 1985, introduced by section 131 of the Companies Act 1989) its correctness as a matter of common law was not in doubt and was taken as read by both counsel in argument and by Robert Walker J, the Court of Appeal and the House of Lords. Eiffel argued that critically the basis for the key to the distinction drawn by the House of Lords in *Soden* (between a claim for misrepresentation inducing a subscription agreement with the company and one inducing a market purchase) was that in the former case, the acquiring shareholder had contributed the capital, which in economic terms he sought to recover from the company, whereas in the latter case he had not. Accordingly, the distinction could and should be explained as one based on the need to respect the common law rule prohibiting a return of capital save as permitted by statute.

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42. In *Soden* (at page 326), Lord Browne-Wilkinson had said as follows (underlining added):

> "*If such a payment [to contribute the sums not previously paid on shares] were not made the capital of the company would not be maintained and the general body of creditors would thereby be prejudiced. If, in such a case, the member could recover by way of damages for breach of the contract to issue the shares at a discount the same amount as he was bound to contribute on the winding up that would indirectly produce an unauthorised reduction of capital of the company. Such a failure to maintain the capital of the company would be in conflict with what Lord MacNaghten (in the Ooregum case [1892] AC 125, 145) said was the dominant and cardinal principle of the Companies Acts, i.e., "that the investor shall purchase immunity from liability beyond a certain limit, on the terms that there shall be and remain a liability up to that limit.*""

43. Eiffel submitted that this view and analysis was consistent with other judicial explanations for *Houldsworth*, to the effect that the winding up order put an end to the normal relationships between the shareholders, creditors and the company (see for example, *Re Hull & County Bank (Burgess' Case)* (1880) 15 Ch D 507 (***Burgess' Case***) and *Southern British National Trust v Pither* (1937) 57 CLR 89, at 113, 114 per Dixon J). Furthermore, this view was supported by the analysis of a highly regarded company law specialist, Professor Gower in *The Principles of Modern Company Law* (2nd Edn., 1957 at pages 295-6) where the decision in *Houldsworth* had been justified on two grounds. First, that to recover damages would be inconsistent with the terms of the implied contract between all shareholders. Second, that the company's share capital should be recognised as "*a guarantee fund for creditors*."

44. Eiffel submitted that there is a common law rule in the form articulated by Lord Browne-Wilkinson in *Soden*. This rule, or principle, had been assumed without argument to be correct in this jurisdiction in the judgment of the former Chief Justice (Smellie CJ) in *Re SPhinX* [2010 (2) CILR 1] (which I discuss further below) and had been approved as part of the *ratio* in decisions of the English Court of Appeal (*Addlestone*) and House of Lords (*Soden*). Even if it was arguable, Eiffel said, that Lord Browne-Wilkinson's observations in *Soden* were *obiter,* they remained of very great persuasive authority and should be followed by this Court.

Gower

45. I have noted Eiffel's reference to Professor Gower's discussion of this issue in the second edition of his well-known company law textbook (as had Justice Tadgell in *Webb*). It is worth noting what Professor Gower had said:

> *"In fact, however, it seems clear that the company is not liable in damages when shares have been purchased in such circumstances. This is because of the anomalous rule, laid down by the House of Lords in Houldsworth v. City of Glasgow Bank, to the effect that damages cannot be recovered from the company unless the allotment of shares is also rescinded. In laying down this rule the House do not seem to have recognised fully the separation between the corporate entity and the member, but the decision can be explained on two grounds. The first is that to recover damages would be inconsistent with the terms of the implied contract between all the shareholders …The second justification depends on the recognition of share capital as a guarantee fund for creditors……As we shall see, this conception is at the basis of the rule that a shareholder who wishes to rescind must do so promptly, since the existence of his shares may have led others to extend credit to the company. But if a shareholder were permitted to recover damages notwithstanding that he had lost the right to rescind, the consequences to third parties would be just as detrimental, since the assets of the company would be equally depleted."*

46. Eiffel submitted that this discussion (written in 1957) could be treated as representing a fair analysis of the English common law at that date. Although Professor Gower (generally recognised to be a leading authority on company law) had said that the rule in *Houldsworth* was "*anomalous*", he had offered a principled justification for it. There was no trace in Professor Gower's analysis of an attempt to distinguish *Houldsworth* or to confine it to its Victorian past or to say that it only applied to unlimited companies or partnerships or, critically, to say that it only applied to claims for damages representing unclaimed calls or amounts outstanding from shareholders and had no application to cases where the shareholder held fully paid-up shares.

Can Houldsworth, or the proposition of law based on it relied on by Eiffel, be distinguished in this case?

47. Eiffel rejected, for the reasons I have summarised, the grounds on which the JOLs sought to say that *Houldsworth* and *Addlestone* were distinguishable. It was irrelevant that the Investors are not obligors to DLIFF under the statutory contract. Furthermore, although

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it was true that in the modern era companies did not tend to issue partly paid shares, that was not always the case and there were many cases in which articles placed continuing financial obligations on members. Indeed, the articles in this case did so. Article 6.6 relating to a placement fee and article 6.7 relating to an equalisation credit imposed liabilities that the directors were permitted to impose on members at their discretion.

48. Eiffel also rejected the JOLs' argument (which I summarise below) that allowing the Misrepresentation Claims to be admitted to proof would not result in a breach of the capital maintenance rules or a return of capital as a matter of Cayman Islands law. The JOLs argued that the subscription price paid by the Investors in this case (and in most cases involving Cayman funds) was largely premium and the capital maintenance rules in this jurisdiction (as contained in the Companies Act since 2011) did not impose a solvency test where on a redemption of shares the redemption price was paid out of the share premium account. Eiffel argued that the JOLs' position was based on the proposition that the Misrepresentation Claims were to be treated as in substance claims for the return of the premium paid and as a redemption. This, Eiffel submitted, was wrong.

49. Eiffel said that the JOLs had argued that under modern investment arrangements in the Cayman Islands' financial industry an investor's subscription price often included a substantial premium and therefore returning it to him by way of damages was not (at least to that extent) a return of capital. Eiffel accepted that the Privy Council had confirmed in *DD Growth Premium v RMF Market Neutral Strategies* [2018] BCC 152 (***DD Growth***) that, since 2011, Cayman Islands company law had allowed redemption payments out of a share premium account without the need to satisfy the solvency test. However, Eiffel submitted that it did not follow from this that the admission to proof of the Misrepresentation Claims was permissible and unaffected by the capital maintenance rules. Admission of (and payment of a dividend on) the Misrepresentation Claims was not the equivalent of paying the redemption price out of the share premium account. Eiffel argued that the Misrepresentation Claims were for damages for misrepresentation, which sought to put the Misrepresentation Claimants in the position they would have been in had they not invested at all. That inevitably involved them receiving and included compensatory damages for having contributed an

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amount which represented the base capital invested. The damages (and sums sought by the Misrepresentation Claimants) were a proxy for the return of capital.

50. Eiffel argued that while it might be technically correct to say that the shares were purchased by Investors at a premium, and that the premium was then allocated to a share premium account which did not form part of the company's base capital, it was irrelevant in this case. Eiffel submitted that if Investors were permitted to prove for damages for misrepresentation in the amount of the whole of their invested capital, including the premium to par, that would drive a coach and horses through section 34(2) of the Companies Act which prohibited a *distribution* of that part of a company's capital (i.e., that part allocated or transferred to the share premium account) to members unless the company was cash flow solvent. It would be inconsistent, Eiffel said, to require cash flow solvency as a pre-condition to a distribution to members out of the share premium account but to allow the sums credited to that account to be available to meet a proof for damages claimed by a member for misrepresentation, in the amount of the premium he/she had paid for his/her shares. The JOLs' argument based on *DD Growth*, that there was no solvency test governing distributions to shareholders from the share premium account, was wrong. Although there was no solvency test for the payment of redemption monies out of the share premium account, that was not the case for "*distributions or dividends*." A payment of damages for misrepresentation was not the payment of the redemption price or analogous to such a payment. It was, at least in commercial terms, the making of a return of capital to the member (that is, a distribution) and the payment of such damages was not a permitted use of the share premium account at all. Eiffel submitted that it would be surprising (and inconsistent with the purpose of the relevant provisions in the Companies Act) if the sums credited to the share premium account could not only be used for that purpose but could be paid away free from any solvency condition. The flaw in the JOLs' argument was to equate damages for misrepresentation with a claim for the redemption price.

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The judicial treatment of Houldsworth (and the Houldsworth Principle) in other common law jurisdictions

51. Eiffel submits that no authority had gone so far, at least in terms of its *ratio*, as to decide that *Houldsworth* (or the Houldsworth Principle) were no longer good law or part of the common law.

52. Eiffel says that:

(a). *Houldsworth* has been followed and applied in Australia and Canada (see *Re Dividend Fund Inc (in liquidation)* [1974] VR 451*; Milne v Durham Hosiery Mills* (1925) 3 DLR 725 and *Webb* at 405-406).

(b). in *Re Televest* [1995] Bda LR 71 (***Televest***) the Supreme Court of Bermuda (Ground J) declined to refuse to follow *Houldsworth* (implicitly accepting its correctness in law) but chose to distinguish it on the facts.

(c). in the recent decision of the Singapore High Court (Justice Chua Lee Ming) in *Song Jianbo v Sunmax Global Capital Fund 1 Pte Ltd & Li Hua* [2021] SGHC 217 (***Song Jianbo***), the court did doubt that *Houldsworth* should be followed but in the end distinguished it. The grounds of distinction (that the liability of the shareholders in this case was limited and that the shares were redeemable) were, Eiffel argued, inapposite since the company in question had not actually been wound up.

(d). the decision of the High Court of Australia in *Sons of Gwalia Ltd v Margaretic* [2007] 3 LRC 462 (***Sons of Gwalia***), on which the JOLs placed great reliance, was certainly critical of *Houldsworth* in different ways in *obiter dicta* across the six judgments but the actual *ratio* of the decision was concerned with the priority to be accorded to a claim by a member for damages for misrepresentation under the applicable legislation and not the availability of a proof in a winding up.

53. Eiffel submitted that in *Televest* while Mr Justice Ground had declined to follow *Houldsworth,* he had accepted its correctness in law and chose to distinguish it. Eiffel noted that Ground J did not say that just because the principle in *Houldsworth* had been abrogated in the UK he was free to disregard it. Instead, he distinguished *Houldsworth*

on the basis, among other things, that it was a case dealing with an unlimited liability partnership where the shareholder concerned owed call monies. He also distinguished *Houldsworth* as a business from the company in the case before him, which was an investment vehicle. Eiffel submitted that this Court should not follow Ground J's decision. First, at least based on the report of his judgment, Mr Justice Ground had not had the benefit of full argument on the issue (as had been the case here). Second, it was unclear as to what he meant and what was covered by his reference to an "*investment vehicle*" (was a holding company or only a fund covered?) and treating such vehicles as outside the rule in *Houldsworth* was not based on any clear principle. It did not appear that Ground J had considered *Addlestone* (a case in which the company concerned was limited) or *Burgess* and *Televest* was decided before *Soden*.

54. Eiffel made a number of points in relation to *Sons of Gwalia*:

(a). first, the case was distinguishable from the present case on the basis that unlike the Misrepresentation Claimants, Mr Margaretic did not acquire his shares by subscription but on the open market from a third party (the case considered the scope and effect of section 563A of the Corporations Act 2001 (the ***2001 Act***) which stated that "*payment of a debt owed by a company to a person in the person's capacity as a member of the company whether by way of dividends profits or otherwise is to be postponed until all debts owed to or claims made by persons otherwise than as members have been satisfied*"). The case was therefore on all fours with *Soden* in that the damages claim was admissible to proof and was not subordinated.

(b). the analysis and discussion of *Houldsworth* was *obiter* in the decision of the majority (comprising Justices Heydon, Hayne, Gleeson, Gummow, Kirby and Crennan). Eiffel reviewed their decision and reasoning as follows.

(c). Eiffel submitted that Justice Heydon had correctly described the irrelevance of *Houldsworth* and the basis and *ratio* of the High Court's ruling in his short judgment at [260]-[264]. Heydon J had agreed with the orders proposed by Hayne J on the issue of whether Mr Margaretic's claim was within section 553 of the 2001

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Act and was therefore subordinated. As regards *Houldsworth,* Justice Heydon had said that (underlining added):

> *"[263]*   *<u>So far as Webb … and Houldsworth …were relied on by Gwalia and ING in relation to the construction of s 563A, it is not necessary to say more about them than that which Hayne J has said in explaining why they are not determinative (see Hayne J's reasons at paras [180]–[190], above) [and we can look at that]. Further, the issue on which the Webb case was decided was whether a claim was provable, whereas the issue on which the Gwalia appeal is to be decided in relation to s 563A turns on whether a provable claim ranks after or alongside the claims of general creditors.</u>*
>
> *[264].*   *So far as those cases were relied on by ING in its written submissions in chief in support of a contention that Mr Margaretic's claim was not provable, by reason of a principle which, it contended, had been stated in Houldsworth's case and approved by this court in the Webb case, it is not necessary to deal with them. That is because both at the start and at the close of his final address, counsel for ING abandoned that contention. If that contention was not abandoned, I agree with Hayne J's reasons for rejecting it …"*

(d). Justice Hayne had also considered that the case was not about the Houldsworth Principle. Justice Hayne had formulated the question to be decided at [135] (does a shareholder's claim in deceit or under the applicable consumer and investor protection statutes rank with the claims of other creditors or is it postponed?) and then said (at [136]) that the questions in the case were to be answered by reference to the applicable statutory regime, in particular sections 553 and 563A of the 2001 Act and did not depend upon any principle of judge-made law: "*In particular, they do not depend upon the application, or the identification of the content, of what is sometimes called 'the rule in Houldsworth's Case'*." Justice Hayne had also noted that after the conclusion of oral argument on the appeal the parties had been asked to make submissions about whether Mr Margaretic's claim was a provable debt which Eiffel said might explain why *Houldsworth* came to be considered by the High Court and why it was dealt with in a somewhat piecemeal manner.

(e). Gleeson CJ had noted that the principal issue in the case was whether "*the (assumed) liability*" of Sons of Gwalia (the company) was a liability to Mr

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Margaretic in his capacity a member and had dealt with *Houldsworth* under the heading "*A Preliminary Question.*" The Chief Justice had noted (at [13]) that according to the second appellant (ING) there was a principle of the common law emerging from *Houldsworth* which precluded a shareholder from proving in a winding up for damages for misrepresentation inducing any acquisition of shares unless the shareholder had first rescinded the membership contract but that once the company had gone into liquidation, rescission was no longer available. ING had submitted that if that was correct, section 563A of the 2001 Act could not apply because the section assumed and subordinated a liability which did not exist. The Chief Justice noted that Mr Margaretic was not a party to any contract with the company for the acquisition of the shares. While he had said that the "*principle in Houldsworth [was] famously elusive"* his conclusion had been that, while "*Houldsworth was never authority for a principle as wide as that asserted by ING*" the appeal "*was to be decided upon the true construction of the provisions of the 2001 Act and in particular section 563A*."

(f). Justice Gummow agreed with the decision of Justice Hayne. Eiffel said that even though he had dealt with *Houldsworth* at length, had sought to explain what the decision was to be understood as standing for and had said that "*there was much to be said for the view that a company satisfying its liability in tort to a member should not be characterised as attempting an unauthorised return of capital*" (at [85]), he had, importantly, concluded that both "*the 'principle' attributed to Houldsworth and Houldsworth itself [had nothing] to do with the presently relevant provisions of the 2001 Act*" (see [86]). Eiffel noted Justice Gummow's rejection of the proposition that as a matter of Australian law there was a common law principle derived from *Houldsworth* that prevented "*a shareholder claim such as that of Mr Margaretic arising in the first place, irrespective of statutory issues respecting admission to proof and ranking of claims*" and his view that *Houldsworth* "*did not supply the support relied upon for the reasoning in Webb"* but submitted that these views were not part of the reasoning which supported his decision in the case and in any event should not be followed by this Court. For completeness, it is worth quoting what Justice Gummow said. He had prefaced his discussion of *Houldsworth* by noting that the need to deal with the decision arose because of the way that ING had put its case. At [47]-[49] he had said this (underlining added):

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"47. "In what follows, I deal further with two additional and related points. The first is the adequacy of the reasons given in Webb … and the second is the dependence upon that reasoning of a principle said to be derived from the speeches in the House of Lords in Houldsworth …

48. It also is appropriate to deal in some detail with Houldsworth for a particular reason, which emerges from the way in which ING put its case on what would be a threshold issue. <u>In its written submissions ING submitted that 'the principle in Houldsworth' prevented, as a matter of common law, a shareholder claim such as that of Mr Margaretic arising in the first place, irrespective of statutory issues respecting admission to proof and ranking of claims. In the course of oral argument counsel appeared to shift ground but, however that may be, in subsequent supplementary written submissions ING again invoked 'the rule in Houldsworth' and its significance for Webb, upon which decision ING relied</u>.

49. As these reasons will seek to demonstrate, in Australia the existence of any such common law 'principle' of company law based upon Houldsworth should be rejected. Further Houldsworth did not supply the support relied upon for the reasoning in Webb."

(g). Justice Kirby had focussed on and agreed with the approach adopted by the Chief Justice to the construction of section 563A. He was not concerned to analyse and assess whether Mr Margaretic was entitled to maintain a proof. Justice Kirby referred (at [103]) to the result of the appeal as being that "*any 'debt' later demonstrated to be 'owed'*" by the company to Mr Margaretic would not be postponed to the debts owed to the general creditors.

(h). Eiffel submitted that it was not possible to distil a single rationale from these judgments which was critical of *Houldsworth* and undermined the propositions of law which Eiffel argued *Houldsworth* stood as authority for, nor which provided a clear and cogent justification as to why *Houldsworth* (and those propositions of law) should not be followed in any modern common law jurisdiction which had not statutorily modified or abrogated them. *Sons of Gwalia* was not a decision forming part of English law or the law of the Cayman Islands and there was much in the reasoning, particularly that of Justice Gummow, that was focussed on the position in Australia, in particular dealing with the impact on the decision of the need to interpret and give effect to Australian investor protection legislation.

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The irrelevance in this jurisdiction of the statutory reversals of the Houldsworth Principle in other jurisdictions

55. Eiffel argued that the bar on claims for damages for misrepresentation by shareholders against the company remained part of the English common law until it was reversed or substantially modified by section 111A of the Companies Act 1985, introduced by section 131 of the Companies Act 1989. That statutory provision was now contained in section 655 of the UK Companies Act 2006 and stated as follows:

> *"A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register of members… in respect of shares."*

56. Eiffel submitted that this Court should therefore proceed on the basis that the principle in *Houldsworth* was properly part of English law until the Companies Act 1989 came into force and that it required statutory intervention to reverse it. That was clear from the debate which had preceded the enactment of section 131 of the Companies Act 1989, which was said to have been supported by a memorandum from the Law Society. That memorandum appeared to have been the output of a wide consultation among the legal profession and the financial sector at the time and section 131 was one part of the UK's broader de-regulation of the financial markets in the mid-1980s and the concomitant investor protections.

57. Eiffel noted and of course accepted that legislative bodies in some other common law jurisdictions had passed legislation to similar effect. This had been done in Bermuda by section 54A of the Companies Act 1981, with effect from 23 July 1999; in Australia by section 247E of the 2001 Act with effect from 18 December 2010 and in Hong Kong by section 40B of the Companies Ordinance (Winding Up and Miscellaneous Provisions) (Cap 32), enacted by section 10 of the Companies (Amendment) Ordinance (Ord No 3 of 1997), with effect from 10 February 1997. However, other legislatures had not done so. Canada, New Zealand, Singapore and the BVI have not enacted equivalent legislation. In fact, in Canada the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act were amended in 2009 in order expressly to subordinate misrepresentation claims.

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58. Eiffel submitted that this Court should therefore proceed on the basis that reversal or modification of *Houldsworth* was a matter for the Cayman Parliament following proper consultation and that since to date Parliament had not seen fit to enact legislation to reverse or modify *Houldsworth*, the Court should continue to respect and apply it.

Can and should this Court refuse to follow the Houldsworth Principle?

59. Eiffel submitted that this Court cannot and should not refuse to follow *Houldsworth* and the Houldsworth Principle.

60. Eiffel said that two related questions arose for consideration. First, what would be the basis on which the Court could refuse to follow *Houldsworth* and the Houldsworth Principle? Secondly, what approach to the existing law should the Court adopt?

61. Eiffel cited a number of well-known decisions including *Frankland v R* 1987-89 MLR 65 (an appeal to the Privy Council from the Isle of Man); *Willers v Joyce & Anor (No 2)* [2018] AC 843 (UK Supreme Court); *National Trust for Cayman Islands v Planning Appeals Tribunal* [2002] CILR 59; *Schramm and Hiscox Syndicate 33 v Financial Secretary* [2004-05] CILR 104 (Cayman Court of Appeal); *Arnage v Walkers (*Mr Justice Doyle, unreported, 5 May 2021) and *International Energy Group Ltd and Zurich Insurance plc UK Branch* [2016] AC 509 (UK Supreme Court).

62. Eiffel made the following points based on, and relied in particular on the following passages in, these judgments:

(a). Sanderson J had set out the proper approach in *National Trust* (at [19]) (underlining added):

> *"As the Court of Appeal in Miller v R has acknowledged (1998 CILR at 164), unanimous decisions of the English Court of Appeal are strong persuasive authority locally but not binding authority. In de Lasala v de Lasala [1980] AC 546, <u>the Privy Council stated that on questions of the common law, a decision of the House of Lords was of very great persuasive authority locally because of the common membership of those courts. However, it stated that this principle does not apply where circumstances locally make it inappropriate to develop a field of common law in a manner similar to England.</u>"*

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(b). in *Schramm,* the Court of Appeal had considered the circumstances in which a local Cayman judge could fill a gap in the common law in order to follow legislative changes made in England. The background was that in England, before legislation had cured the problem, there could be no restoration to the register of a company dissolved following a voluntary winding up. That problem had been cured by statute but similar legislation had not been enacted here. The Court of Appeal held that it was not the judicial function to fill the gap and amend the law here to achieve the same result. Just because the UK Parliament had enacted company law legislation to correct an allegedly perceived injustice does not justify this Court from amending the law by judicial decision (so that *Schramm* is on all fours with the present case and met the JOLs' argument that *Houldsworth* should no longer be regarded as good law because it has been reversed by statute in the UK). At [8] of his judgment, Collett JA had said that (underlining added):

> *"By contrast, the Cayman companies legislation, enacted by the local legislature since it ceased to be a dependency of Jamaica, has always based itself upon the 1865 legislation of the United Kingdom and not the later models. Extensive overhaul of this legislation was undertaken here at the end of the 1980s but, despite that review, no decision was taken to follow the later UK models instead. That decision must be regarded as a deliberate one on the part of the well-informed local legislature and is readily to be understood as a reaction to the establishment of the formidable array of offshore companies registered in these Islands, which present a scenario unlike that of the United Kingdom, Canada, Australia or other established countries of the Commonwealth: they do not, to anything like the same extent, seek to attract overseas business incorporations. Occasional injustice must be regarded as the price which the local legislature has considered to be worth permitting to occur rather than to introduce the uncertainties which might plague the Law if the more recent English precedents, or indeed those very recently introduced in Australia, were to be adopted here. Indeed Australia has radically reformed its legislation within the recent past."*

(c). in *International Energy Group* (at page 209), Lord Neuberger said that (underlining added):

> *"In conclusion, it seems to us that it is at least worth considering what lessons can be learnt from the history summarised in this judgment and more fully treated by Lord Mance and Lord Sumption JJSC. There is often much to be said for the courts developing the common law to achieve what appears to be*

a just result in a particular type of case, even though it involves departing from established common law principles. Indeed, it can be said with force that that precisely reflects the genius of the common law, namely its ability to develop and adapt with the benefit of experience. However, in some types of case, it is better for the courts to accept that common law principle precludes a fair result, and to say so, on the basis that it is then up to Parliament (often with the assistance of the Law Commission) to sort the law out. In particular, the courts need to recognise that, unlike Parliament, they cannot legislate in the public interest for special cases, and they risk sowing confusion in the common law if they attempt to do so.

When the issue is potentially wide ranging with significant and unforeseeable (especially known unknown) implications, judges may be well advised to conclude that the legislature should be better able than the courts to deal with the matter in a comprehensive and coherent way. It can fairly be said that the problem for the courts in taking such a course is that the judges cannot be sure whether Parliament will act to remedy what the courts may regard as an injustice. The answer to that may be for the courts to make it clear that they are giving Parliament the opportunity to legislate, and, if it does not do so, the courts may then reconsider their reluctance to develop the common law. For the courts to develop the law on a case-by-case basis, pragmatically but without any clear basis in principle, as each decision leads to a new set of problems requiring resolution at the highest level, as has happened in relation to mesothelioma claims, is not satisfactory either in terms of legal certainty or in terms of public time and money."

63. Eiffel submitted that under established practice this Court will generally apply the English common law save to the extent that it has been overruled by or was inconsistent with Cayman legislation or where the Court had developed the common law in this jurisdiction in a materially different way from that in England. Eiffel noted that the Privy Council was not bound by the English common law (or decisions of the House of Lords or Supreme Court) where local conditions required that a different approach be taken (see Mance and Turner, *Privy Council Practice* (2017) at [5.30]-[5.31]). Eiffel argued that there was nothing inappropriate about following *Houldsworth* and the Houldsworth Principle and there was no Cayman custom, practice or trend that had been identified that would suggest that the law as established thereby was causing a problem in the Cayman Islands such that it should not be followed, or that the Privy Council would regard itself as free to depart from it because of something particular to the Cayman Islands.

64. Eiffel argued that Parliament has had thirty-three years to follow the UK Parliament and enact the equivalent of section 131 of the UK's Companies Act 1989 (now section 655 of the UK 2006 Companies Act); twenty-three years to follow the Bermuda legislature

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and twenty-five years to follow Hong Kong, but it had not done so. The Companies Act was regularly reviewed and frequently revised so that it was most unlikely that the absence of a statutory reversal of *Houldsworth* was the result of an oversight.

65. Furthermore, Eiffel submitted that it would be positively dangerous for the Court to "*play lawmaker*." Given the enormous importance of certainty to investors who choose to invest in this jurisdiction it would be rash for the Court to create a new class of potential creditor (who would, if the JOLs were right) take priority over even fully redeemed but unpaid investors in a winding up. It was reasonable to infer that those who invest in Cayman Islands' companies by way of acquiring redeemable shares did so on the basis of the law as it stands (or was understood), namely that whether they have redeemed or not as at the date of the winding up, they will not have to compete *pari passu* with (let alone be subordinated to) members who were misled by the company into investing and want their investment back. Eiffel said that if the law in Cayman was to adopt that position then the widest prior consultation among the financial community was essential. Only Parliament could do that, as the UK Parliament had done in the late 1980s before enacting section 131 of the Companies Act 1989. Standing back, Eiffel said, a refusal now by this Court to follow *Houldsworth* risked serious adverse and unintended consequences. For example, there were many ordinary Cayman companies that were not engaged in the investment or funds industry for whom the consequences would need to be considered (*Houldsworth* applied to all of them). Further, it could be assumed that currently ordinary unsecured creditors and lenders dealt with and invest in Cayman companies on the basis that misrepresentation claims would not be admitted to proof. If all investors were now permitted to rank *pari passu* with unsecured creditors, it might have a serious impact on the willingness of unsecured lenders to lend. There was also the risk of opening the floodgates to investor claims for misrepresentation and in turn burdening officeholders with a potentially unmanageable adjudications process.

The Proof Point - the JOLs' position

Proper approach and merits

66. The JOLs said that in addressing the availability (and priority) of damages claims made by shareholders based upon misrepresentation, it was necessary to begin by examining

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the decision in *Houldsworth* and its subsequent judicial treatment by foreign courts, noting that such decisions were persuasive but not determinative. As I note below, the JOLs submitted that there was no Cayman Islands authority which determined whether *Houldsworth* was good law and should be followed in this jurisdiction.

67. In the JOLs' view, in terms of merits, considerations of fairness supported allowing the Misrepresentation Claimants to claim as creditors (and to rank *pari passu* with other creditors). This was because DLIFF (and DLIF) had been operated as a massive fraud from the beginning and the JOLs could not see why, as a matter of fairness, Investors who had, by mere good fortune, lodged their redemption requests shortly before the commencement of the liquidation should enjoy priority over the other Investors who had failed for whatever reason to do so. All (or most) of the Investors were, in substance, in the same position and had probably been induced to invest by the fraud of DLIFF's management and there was no reason why the law should produce a result which prioritised and preferred some of the Investors over others. The JOLs said that *Houldsworth* and *Addlestone* were the only two English cases in which the so-called Houldsworth Principle had been applied to bar misrepresentation claims by shareholders and on the basis of the *ratio* of those decisions, they only applied to a case where the shareholder was under a liability to contribute funds to the company in liquidation in order to meet the claims of creditors and what the shareholder was not allowed to do was to assert what was, in effect, an offsetting damages claim to evade that subsisting liability to contribute.

Houldsworth

68. The JOLs submitted that the true scope of the principle for which *Houldsworth* was authority (as Gleeson CJ had noted in *Sons of Gwalia*) had been set out by Lindley LJ in *Addlestone* (at pages 205-206) as follows: "*The principle on which the House of Lords decided Houldsworth .... was that a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that it is inconsistent with his position as a shareholder, while he remains such, to claim back any of that money - he must not directly or indirectly receive back any part of it*." Where a shareholder was liable to make a contribution to be applied in payment of the debts and liabilities of the company then it was inconsistent with his position as a shareholder to

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claim back any of that money. The reason why Mr Houldsworth's claim was rejected was that his claim for damages was inconsistent with his contract of membership, which contract could not be rescinded given the liquidation of the company. Eiffel's formulation of the proposition of law to be derived from *Houldsworth* was too broad.

69. The JOLs noted that the House of Lords (comprising Lord Chancellor Earl Cairns, Lord Selborne, Lord Hatherley and Lord Blackburn) had agreed with the decision of the Court of Session and held that Mr Houldsworth could not maintain his claim for damages. The JOLs said that their Lordships had held that (a) as the winding-up had commenced, it was too late for rescission and *restitutio in integrum* (based on the decisions in *Oakes v Turquand* (1867) LR 2 HL 325 and *Tennent*) and (b) in those circumstances, Mr Houldsworth's claim for damages would not be allowed on the basis that it was inconsistent with his outstanding obligations (under the statutory contract).

70. The Lord Chancellor, Earl Cairns, had considered the decision of the House of Lords in *Addie v The Western Bank of Scotland* (1867) LR 1 HL 145 to be of sufficient authority to "*go far, if it did not go the whole way, to decide the present appeal*" but also invited their Lordships "*to look at the case on principle.*" He had identified the question of principle to be decided as follows:

> *"The question, therefore, mainly argued at your Lordships' Bar, and upon which the decision of this case must, as I think, depend, was this: Can a man, induced by the fraudulent misrepresentations of agents of a company to take shares in the company, after he discovers the fraud, elect to retain the shares, and to sue the company for damages?"*

71. Earl Cairns had considered that Mr Houldsworth's action for damages was inconsistent with his contract of membership and that, having affirmed the contract of subscription, Mr Houldsworth was impermissibly seeking to approbate and reprobate. He said this (at pages 324-325) (underlining and emphasis added):

> *"A man buys from a banking company shares or stock of such an amount as that he becomes, we will say, the proprietor of one hundredth part of the capital of the company. A representation is made to him on behalf of the company that the liabilities of the company are £100,000, and no more. His contract, as between himself and those with whom he becomes a partner, is that he will be entitled to one hundredth part of all the property of the company, and that the assets of the company shall be applied in meeting the liabilities of the company contracted up*

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to the time of his joining them, whatever their amount may be, and those to be contracted afterwards, and that if those assets are deficient the deficiency shall be made good by the shareholders rateably in proportion to their shares in the capital of the company. This is the contract, and the only contract, made between him and his partners, and it is only through this contract, and through the correlative contract of his partners with him, that any liability of him or them can be enforced.

……..

He finds out, however, after he joins the company, that the liabilities were not £100,000 but £500,000. He is entitled thereupon, as I will assume, to rescind his contract, to leave the company, and to recover any money he has paid or any damages he has sustained; ***but he prefers to remain in the company and to affirm his contract****, that is to say, the contract by which he agreed that the assets of the company should be applied in paying its antecedent debts and liabilities.* ***He then brings an action against the company to recover out of its assets the sum, say £4000, which it will fall upon his share to provide for the liabilities, over and above what his share would have had to provide had the liabilities been as they were represented to him****. If he succeeds in that action, this £4000 will be paid out of the assets and contributions of the company. But he has contracted, and his contract remains, that these assets and contributions shall be applied in payment of the debts and liabilities of the company, among which, as I have said, this £4000 could not be reckoned.* ***The result is, he is making a claim which is inconsistent with the contract into which he has entered, and by which he wishes to abide; in other words, he is in substance, if not in form, taking the course which is described as approbating and reprobating, a course which is not allowed either in Scotch or English law****."*

72. The JOLs submitted that the essence of Lord Cairns' reasoning was founded on the characterisation of Mr Houldsworth as a partner, which in substance he was, because he had originally started a partnership and once it was incorporated, it was incorporated as an unlimited company. Therefore, Mr Houldsworth remained liable as shareholder to meet all the assets and liabilities of the partnership and it was not within the intent or scope of the partnership contract that the assets and liabilities of the partnership should be applied in satisfying a liability which was due to him.

73. The JOLs noted that Lord Selborne considered Mr Houldsworth's claim for damages to be inconsistent with his (unrescinded) contract of membership with the company. He said this (at page 329) (underlining added):

"[here] it is impossible to separate the matter of the Pursuer's claim from his status as a corporator, unless that status can be put an end to by rescinding the contract which brought him into it. His complaint is that by means of the fraud alleged he was induced to take upon himself the liabilities of a shareholder. <u>The loss from</u>

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<u>which he seeks to be indemnified by damages is really neither more nor less than the whole aliquot share due from him in contribution of the whole debts and liabilities of the company; and if his claim is right in principle I fail to see how the remedy founded on that principle can stop short of going this length. But it is of the essence of the contract between the shareholders (as long as it remains unrescinded) that they should all contribute equally to the payment of all the company's debts and liabilities</u>."

74. The JOLs submitted that Lord Selborne had treated Mr Houldsworth's claim as being one that in substance was made against the other partners so that he was seeking to put upon them the share of the debts and liabilities of the partnership which he, by being one of the co-partners, had agreed to bear. Lord Selborne's reasoning was founded on notions of partnerships, the rights and obligations of partners, transmuted through, in this case, to an unlimited company. Furthermore, his reasoning suggested that the corporation may not be a separate legal entity and it was relevant to recall that the judgment was handed down in advance of the House of Lords' decision in *Salomon v Salomon* [1897] AC 22. The JOLs said that it had to be borne in mind that *Houldsworth* had been decided at a fairly early stage in the development of English company law and that the partnership model had strongly informed the legal analysis (reinforced by the facts of the case, given the history of the company and the fact that it was an unlimited company).

75. The JOLs said that Lord Hatherley had also considered (at page 333) that Mr Houldsworth's status as shareholder was "*fatal to [his] right to the relief he asks*" and that he was "*trying to reconcile two inconsistent positions, namely, that of shareholder and that of creditor of the whole body of shareholders including himself*."

76. The JOLs submitted that when considering the inconsistency relied on it was important to remember that the company in *Houldsworth* was an unlimited company. Since it was an unlimited company Mr Houldsworth became liable to pay calls as a contributory and the liability was unlimited. What he therefore sought to do by his action for damages was, in effect, to obtain from the company reimbursement in respect of his liability to pay calls in the winding up of the company, in circumstances where he could no longer obtain rescission of the contract of allotment pursuant to which he had acquired the shares which exposed him to the liability to pay calls. As such, he was seeking to avoid his liability as a shareholder and to reduce the capital of the company available to meet the claims of creditors.

Addlestone

77. The JOLs noted that *Addlestone* concerned a limited and not an unlimited company but crucially the shares had not been fully paid. While the company had purported to issue £10 preference shares at par, they were in fact issued at a discount. After the company had gone into liquidation, the liquidator made calls on the shareholders for the amounts unpaid on the shares (£2, 10 shillings). The relevant shareholders (the JOLs say no doubt in response) then sought to make claims for damages in respect to the issue of preference shares. Accordingly, the JOLs say, *Addlestone* is a case like *Houldsworth* in the sense that the shareholders were under a liability to contribute to the company albeit that they were not under an uncapped liability to contribute.

78. In these circumstances, it was unsurprising they say that the Court of Appeal (Lindley LJ) had followed *Houldsworth*. He held that *Houldsworth* was authority for the proposition that where a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, then it was inconsistent with his position as a shareholder to seek to claim back any of that money. Therefore, like *Houldsworth*, the decision in *Addlestone* was founded on considerations relating to the maintenance of the company's capital which meant that the damages claim was inconsistent with the plaintiff's obligations as a shareholder.

Webb

79. The JOLs noted that *Houldsworth* and *Addlestone* had been considered by the High Court of Australia in *Webb*. In 1990, three affiliated building societies faced liquidity issues and subsequently went into liquidation. A shareholder, Webb Distributors, was appointed as a representative of the holders of non-withdrawable shares (who claimed they had been deceived as to the nature of their shares). The State of Victoria had been assigned the claims of depositors and so became the societies' majority creditor. The liquidator of the societies sought directions as to whether the shareholders' claims were provable and whether they were precluded from claiming damages due to the Houldsworth Principle.

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80. The majority in the High Court (McHugh J had dissented) had noted that Tadgell J (in the Appeal Division below) had been conscious of the criticisms made of *Houldsworth* but considered (at page 405d-e) that *"[whatever] criticisms may be made of the reasoning in Houldsworth, the decision has been applied or treated as applicable to limited companies not only in the United Kingdom... but also in Australia... and Canada.*" They had also noted that the decision in *Houldsworth* had been explained in various ways but that it was perhaps best explained by Lindley LJ in *Addlestone*. They had said (at page 406h) that "*the critical question is not whether Houldsworth is right or wrong but whether the proposition which the House of Lords distilled in the case from the provisions of the Companies Act 1862 is incorporated in the provisions of the [Companies (Victoria)] Code*". That proposition was said (at page 406h-i) to be that: "*a shareholder may not, directly or indirectly, receive back any part of his or her contribution to the capital of the company*."

81. The relevant provision of the Companies (Victoria) Code was Section 360(1) which is similar in all material respects to section 49(g) of the Companies Act. Both had their origins in Section 38(7) of the UK Companies Act 1862. The majority agreed (at 407c) with the finding of Tadgell J that "*the principle in Houldsworth received statutory recognition in s360(1) of the Code and was therefore imported into the windings up of the three building societies.*" The majority set out their conclusion as follows (at 408c-e):

> "*Paragraph (k) of s 360(1) will not prevent claims by members for damages flowing from a breach of contract separate from the contract to subscribe for the shares.....But, in the present case, the members seek to prove in the liquidation damages which amount to the purchase price of their shares, which is a sum directly related to their shareholding. Moreover, they sue as members, retaining the shares to which they were entitled by virtue of entry into the agreement and they seek to recover damages because the shares are not what they were represented to be. Accordingly, the claim falls within the area which s 360(1)(k) seeks to regulate: the protection of creditors by maintaining the capital of the company.*"

82. The JOLs, relying on what was said about this reasoning in *Sons of Gwalia* by Gleeson CJ (at [14]) and Justice Gummow (at [86]), submitted that the majority in *Webb* were wrong to say that the principle in *Houldsworth* had received statutory recognition in section 360(1) of the Victorian Companies Code since that principle which operated to bar certain claims for damages by a shareholder was obviously different from section

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360(1), which assumed that a claim could be made, and provided for its subordination, in the liquidation (to the claims of other creditors). Moreover, the language of section 360(1), derived from section 38(7) of the 1862 Companies Act, pre-dated the decision in *Houldsworth*. The JOLs also noted that in McHugh J's dissenting opinion he had observed that the principle in *Houldsworth* was "*misconceived because a company is an entity separate from the shareholder*s" and "*a source of injustice because, once the company goes into liquidation, the shareholder can neither rescind the contract of allotment nor obtain damages*." McHugh J had accepted that *Houldsworth* was an entrenched rule of Australian company law and so did not seek to set it aside directly but instead avoided giving effect to the decision by relying on the Trade Practices Act 1974 and by rejecting the argument that the relevant provisions in that Act contained an implied limitation which excluded companies in liquidation.

Soden

83. In 1988, British & Commonwealth Holdings plc (***B&C***) purchased the entire share capital of Atlantic Computers plc for £434m. In 1990, Atlantic Computers went into administration. B&C, which had also gone into administration, brought proceedings against, *inter alia*, Atlantic for damages for negligent misrepresentations said to have been made by Atlantic so as to induce B&C to acquire its shares. The administrators of Atlantic applied to the Court for directions as to the priority of such claims under section 74(2)(f) of the UK Insolvency Act 1986.

84. This was the successor provision to section 38(7) of the UK Companies Act 1862 and was materially similar to both section 360(1)(k) of the Victorian Companies Code and section 49(g) of the Companies Act. It provides as follows:

> *"(1) When a company is wound up, every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories among themselves.*
>
> *(2) This is subject as follows:*
>
> *……..*

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> (d) *in the case of a company limited by shares, no contribution is required from any member exceeding the amount (if any) unpaid on the shares in respect of which he is liable as a present or past member;*
>
> ……..
>
> (f) *a sum due to any member of the company (in his character of a member) by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves."*

85. The question in *Soden* was whether the claim of B&C fell within section 74(2)(f). It was not argued that the claim for damages was barred by *Houldsworth* so that the scope of any principle established by *Houldsworth* did not arise for determination. At first instance, Robert Walker J (as he then was) found that B&C was not claiming in its character as a member and distinguished the decisions in *Addlestone* and *Webb* on the basis they concerned claims by original (i.e. subscribing) members, and that "*by contrast, B&C was never an original member in respect of any shares in Atlantic [and nor does B&C seek] to withdraw from Atlantic, directly or indirectly, any capital which [it] has ever contributed."* The Court of Appeal, in upholding the decision of Robert Walker J, concluded that the majority decision in *Addlestone* and the decision in *Webb* failed to give the proper weight to the statutory language used and considered that there were qualifications upon the principles regarding the maintenance of capital and that members come last. On appeal to the House of Lords, Lord Browne-Wilkinson had delivered a speech with the unanimous support of the other members and, as I have already noted, distinguished for the purposes of section 74(2)(f) between claims for damages for misrepresentation from shareholders who subscribed for shares in the company and claims from shareholders who had acquired shares by purchase. In doing so, he had noted as a "*background point*"" that "*there was a principle established in Houldsworth ..... that a shareholder could not sue for damages for misrepresentation inducing his subscription for shares unless he first rescinded the contract and that once the company had gone into liquidation such rescission was impossible*."

86. The JOLs submitted that Lord Browne-Wilkinson's formulation of the applicable principle and the proposition of law to be derived from *Houldsworth* was both *obiter* and, for the reasons summarised above relating to the JOLs' submissions as to the

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proper interpretation of the basis for the decision in that case, too wide and unsupportable. It should not be treated as authoritative or persuasive and should not be followed by this Court.

Sons of Gwalia

87. The JOLs argued that the decision and reasoning of the majority supported their case. The High Court of Australia had decided that the Houldsworth Principle did not bar Mr Margaretic's claim and also that that claim for damages was not subordinated under s.563A. The JOLs noted that ING had invited the High Court of Australia to find that "*the principle in Houldsworth*" prevented, as a matter of common law, a shareholder claim of the type made by Mr Margaretic from arising, irrespective of statutory issues respecting admission to proof and the ranking of claims. The JOLs argued that, following a detailed analysis of *Houldsworth* and its interpretations in the UK and Australia, the High Court had rejected the existence of any principle of company law that precluded a member from proving in the winding up of a company for damages for misrepresentations inducing the acquisition of shares where the member had not rescinded the contract pursuant to which the shares had been purchased and where rescission was no longer available by reason of the company's insolvency.

88. The JOLs submitted that the majority's decision on the *Houldsworth* point was part of the *ratio*. They said that point had been raised and put before the Court and the High Court had to decide it because if it was right that Mr Margaretic's claim was barred then the asserted subordination did not arise. The JOLs noted that this was supported by the headnote in the law report (at page 464) which stated as follows:

> *" Per Gleeson CJ, Gummow, Kirby, Hayne, Heydon, and Crennan JJ [so that is the six of them. There was one dissent]. There was no general policy in the 2001 Act that members come last and there was no common law principle of company law derived from Houldsworth applicable in Australia, since neither Webb nor Houldsworth itself established any common law principle that a shareholder, no matter how his shares were acquired, could not sue a company to recover losses caused by the company's misrepresentation inducing its acquisition of shares if the company went into liquidation."*

89. The JOLs, like Eiffel, reviewed the reasoning of the majority.

90. They said that Gleeson CJ had analysed *Houldsworth* as involving a shareholder impermissibly seeking to evade his liability to pay calls made and required to be paid in the winding up.

91. The JOLs submitted that Gummow J had mounted a sustained and compelling attack on the claim that *Houldsworth* was authority for the continuing existence of a wide common law rule prohibiting a shareholder from maintaining a claim for damages for misrepresentation inducing his/her purchase of their shares. Gummow J had devoted various sections of his judgment to *Houldsworth* and (at [49]) had clearly rejected the proposition that as a matter of Australian law there was a common law principle derived from *Houldsworth* that prevented "*a shareholder claim such as that of Mr Margaretic arising in the first place, irrespective of statutory issues respecting admission to proof and ranking of claims*" and had said (in the same paragraph) that *Houldsworth* "*did not supply the support relied upon for the reasoning in Webb.*"

92. The JOLs noted and relied on what Gummow J had said about the majority's reasoning in *Webb*. Gummow J had noted the majority's view that the principle that a shareholder may not directly or indirectly receive back any part of his or her contribution to the capital of the company could be derived from *Houldsworth* and had then observed (at [78] and [79]) that:

> "*78. It is not easy to discern why an action for damages was inconsistent with the features of the contract whereby shares were taken up. Nor is it clear why this inconsistency should have prevented the shareholder from claiming that the fraud of the directors was imputable to the company.*
>
> *79 Accordingly, Houldsworth should not be regarded in Australia as establishing any principle based on the above reasoning, nor does it establish any exception respecting the responsibility of a principal for the frauds of an agent ...*"

93. The JOLs noted that Justice Hayne had also considered *Houldsworth* to have been founded upon considerations of preservation of capital:

> *"The conclusion reached in Webb Distributors concerned, and concerned only, the rights of a member who had subscribed for shares, as distinct from having acquired shares by contract from a person other than the company itself. Maintenance of capital may be relevant to a shareholder's entitlement to recover*

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from the company amounts that the shareholder subscribed as capital, but it has no direct relevance to the recovery from the company of damages for loss occasioned by the making of a contract to acquire existing shares in the company from a third party. It has no direct relevance to that second kind of case because the shareholder does not seek the return of what was subscribed as capital when the shares were allotted. Whether, in the first kind of case, it is right to describe the claim as one which seeks the return of what was subscribed is a question that need not be answered here. Even if it were right, it would provide no reason for concluding that a shareholder like Mr Margaretic, who was not a subscriber, has no claim against the company under the consumer and investor protection provisions mentioned at the start of these reasons. Nor would it provide a reason for concluding that such a shareholder had no claim for deceit. Neither Webb Distributors nor Houldsworth established any common law "principle" that no shareholder, no matter how the shares were acquired, can have a claim of the kind now in issue against a company whose assets were to be administered as on a liquidation. The reasoning in those cases, because it was founded in important respects upon considerations of preservation of capital, can have no direct application when the plaintiff shareholder did not subscribe capital. But whether or not that is so, the asserted common law "principle" could not deny the operation of the relevant consumer protection and investor protection provisions. Finally, the conclusion reached in Webb Distributors, like the conclusion reached in Houldsworth, turned, in important respects, upon whether the shareholder could rescind the contract with the company for subscription for shares. None of these considerations is relevant to the present matters where there was no contract for the acquisition of shares made between the shareholder, Mr Margaretic, and the company, SOG. "

94. The JOLs said that Heydon J had agreed with Hayne J on this issue and that Crennan J had agreed with Gummow J.

95. The JOLs noted that subsequently legislation was passed which reversed the decision in *Sons of Gwalia* on the priority point but not on the proof point. The Australian legislature had taken the view that the correct approach was to allow the misrepresentation claims in principle but then to treat them as subordinated. The result was very similar to the current position in England. In Australia, shareholder misrepresentation claims are not barred but are subordinated in a liquidation. In England, shareholder misrepresentation claims are also not barred but there is a distinction on the basis of *Soden* between damages claims arising through a subscription for shares, which are subordinated, and damages claims arising from a transfer of shares, which are not subordinated.

Televest

96. The JOLs invited the Court to follow the approach taken by Mr Justice Ground in *Televest*. They submitted that the facts and issues in *Televest* were essentially the same as in this case and that Ground J had reached the right conclusion for the right reason.

97. Televest Limited was an investment vehicle. Investments were solicited by the issue of prospectuses and investors became the holders of redeemable preference shares. However, not every application for shares succeeded since the various offers were oversubscribed. In such a case the applicant, rather than receiving a refund of his subscription, received a convertible loan note (which notes bore interest at the same rate as the redeemable preference shares and were convertible into such shares at Televest' s option). When Televest went into liquidation there were insufficient funds to pay the notes and the shares so that satisfaction in full of the notes would have substantially depleted the recoveries of the preference shareholders. Ground J said that the "*problem facing the Liquidators [was] that the Preferred Shareholders [were] strictly to be treated as contributories, and hence rank in priority after the note-holders. In reality the satisfaction in full of the note-holder's claims will seriously deplete the assets available for distribution, leaving the preferred shareholders with a much reduced sum between them*."

98. The JOLs agreed that this gave rise to what was clearly seen by the Judge as an odd and unfair situation given the way in which the subscriptions had been made and on the basis that all investors had presumably been equally affected by the misrepresentations made in the prospectuses. Ground J had acknowledged the perceived unfairness when he said that "*If it were simply a question of fairness and equity, [he] would have no doubt that the two classes of investors should be treated equally, and that there should therefore be a pari passu distribution among them*" but also the impact of the *prima facie* legal position resulting from the fact that under the company's legislation the investors as contributories ranked behind the noteholders as creditors. He had noted that "*the problem faced by the preference shareholders was that the common law of England was that a shareholder could not pursue an action for damages for deceit against a company in respect to the contract by which he obtained his shares, unless he was entitled to rescind the contract of allotment: Houldsworth ...* " and that various ways to avoid the

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consequences of the distinction between contributory and creditor were advanced. He rejected the argument that the history of statutory intervention to overturn *Houldsworth* in other jurisdictions (but not Bermuda) was sufficient to make *Houldsworth* bad law in Bermuda and that the fact that the House of Lords rather than the Privy Council had decided the case was relevant. Instead, in a manner that the JOLs submit to be right and justified, he distinguished *Houldsworth* and explained why the facts of *Houldsworth* did not apply to the facts of that case. Ground J set out his reasoning as follows (underlining added):

> *"The speeches of their Lordships in Houldsworth's case make it plain that they are concerned with the case of the shareholder who is in a real sense a member of the company, and can participate in its decisions. It is also plain that they were applying an earlier decision on the facts which were materially similar, Addie v the Western Bank [1867] LR 1 Sc 145, and which they considered was indistinguishable.*
>
> *[He then quoted from the speech of Lord Blackburn in Houldsworth at page 337 where he noted that the contract with a joint stock company to take shares was a very peculiar one since it was in substance an agreement with the company to become a partner in the company on the terms that the partner would in common with all his co-partners for the time being contribute to make good all liabilities of the co-partnership as if this incoming partner had been a member of the partnership from the beginning].*
>
> *"<u>In the instant case, there is no real partnership</u>: the Articles of the company are already in evidence (although not agreed for the purposes of this hearing), and from them it is apparent that the redeemable preference shares carried neither voting rights nor the right to participate in the appointment of directors. To that extent the preferred shareholders were entirely in the hands of the holders of the common shares who constituted the real partnership that controlled the company. <u>Nor did the preferred shareholders contract inter se to contribute to the liabilities of the company in the way envisaged by Lord Blackburn</u>. No call could be made upon them, as the shares were in their nature fully paid up, and <u>while it is true that the extent of the investment was hostage to the fortunes of the company, a shareholder could terminate that liability at any time when the company was solvent by giving notice to redeem. In those circumstances, I do not see why any principle should debar them from seeking remedy in damages, be it for fraud, breach of contract, negligence, or misrepresentation against the company. It is not as if they have in any meaningful sense become a part of the company and are thus essentially suing themselves [which was, of course, one of the points which their Lordships have made in Houldsworth]. If further demonstration were needed, the example given by the Lord Chancellor Earl Cairns at p.325 of the decision in Houldsworth's case, illustrates just how removed the circumstances he was considering are from those of this case</u>."*

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99. The JOLs submitted that Mr Justice Ground had identified two important respects in which *Houldsworth* was distinguishable from the case before him (and that these points applied equally in this case). First, that in *Televest* there was no possibility of the preferred shareholders having a liability to contribute because the shares were fully paid up. Secondly, that because the shares were redeemable shares the investment of the shareholder could be withdrawn at any time simply by operating the mechanics set out in the company's articles of association.

Song Jianbo

100. The JOLs also relied on the decision of the Singapore High Court in *Song Jianbo* where the Court had doubted whether *Houldsworth* should be followed and distinguished it on the basis that Sunmax was a limited company (unlike the City of Glasgow Bank) and that the shareholder's claim did not amount to an impermissible return or reduction of share capital.

Applying the principle and proposition of law properly derived from Houldsworth and the subsequent decisions to this case

101. The JOLs submitted that the Misrepresentation Claims were not barred by any principle established by *Houldsworth*, even if such a principle was considered to form part of the law of the Cayman Islands. This was for two reasons. First, there is no inconsistency between the Misrepresentation Claims and the obligations of the relevant Investors as shareholders in DLIFF. In particular, such claims did not involve the Investors seeking to claim back money which they had contracted to contribute to pay the debts and liabilities of DLIFF. Secondly, the Misrepresentation Claims were not made (and would not in future be made) by the relevant Investors in their capacities as shareholders in DLIFF (this second reason overlaps with the issues arising in relation to the Priority Point).

102. The correctness of the first reason turned on the proper analysis of *Houldsworth*. The JOLs submitted that, based on the authorities on which they relied and their submissions as to what these cases decided, the proposition of law for which *Houldsworth* stands as authority was (as noted above) that summarised by Lindley LJ in *Addlestone*, namely that where a shareholder contracts to contribute a certain amount to be applied in payment

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of the debts and liabilities of the company, then it is inconsistent with his position as a shareholder, while he remains such, to claim back any of that money. This formulation of the applicable proposition of law reflected the analysis of *Houldsworth* by the Australian High Court in both *Webb* and *Sons of Gwalia* and was supported by, in particular, the speech of Lord Cairns in *Houldsworth*. Therefore, the JOLs submitted, the principle was not engaged (and the proposition of law did not bar proofs by the Investors with Misrepresentation Claims) in the present case because:

(a). none of the Investors were under any liability to DLIFF to contribute funds to the winding up. All of the shares were issued as fully paid up and there was no question of the JOLs making any calls on any shareholder.

(b). the Misrepresentation Claimants would not be seeking to avoid obligations under the statutory contract or a return of share capital but simply damages, the measure of which would be contingent upon, *inter alia,* (i) the amount of the subscription monies, (ii) the value of the shares at acquisition and (potentially) disposition, (iii) loss of profits and (iv) benefits.

(c). there was therefore no inconsistency between the relevant Investors asserting Misrepresentation Claims and any obligation on their part to contribute funds in order to pay the debts and liabilities of the DLIFF.

103. The JOLs argued that furthermore the Misrepresentation Claims were likely to be for damages represented (in large part) by the difference between the sums advanced by Investors in return for their shares and the actual value of those shares at the time of disposition (i.e. in the liquidation). To the extent that a damages claim for the difference in value calculated on that basis could be construed as a return of capital (which the JOLs submitted was not the case) it was instructive to consider what element of the subscription actually amounted to share capital (as the concept was understood in *Houldsworth*). Of the sums advanced by Investors for their shares only a very small amount was attributable to share capital, with the vast majority being attributable to premium. The preference shares had a nominal value of one cent per share but were issued for prices at around a $1,000 to $1,200 per share. So the overwhelming majority of each subscription price was premium. The JOLs said that the amount that was not premium was effectively *de minimis*. This was typical the JOLs said for a Cayman Islands investment fund using the

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form of a Cayman exempted limited company issuing redeemable shares (see *DD Growth* at [10]).

104. The JOLs argued that as a matter of Cayman Islands law amounts standing to the credit of the share premium account could not properly be described as share capital. Technically the share premium account did not form part of the share capital. The premium when shares were issued must be credited to the share premium account. This was the result of the provisions of the articles and sections 34 and 37 of the Companies Act.

105. First, the premium had to be paid into a separate account. Article 36 required the directors to establish a share premium account and credit to that account a sum equal to the amount of the premium paid on the issue of any share. Section 34(1) of the Companies Act states that "*Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the value of the premiums on those shares shall be transferred to an account called 'the share premium account.*'"

106. Secondly, payments could be made out of the share premium account to pay the redemption price when shares were redeemed. A company was at liberty to use and pay out the sums credited to its share premium account for various purposes including to pay the redemption price of shares to shareholders:

(a). article 36.2 states that sums credited to the share premium account may be used to pay the premium on the redemption.

(b). section 34(2) of the Companies Act provides that (underlining added):

> "*The share premium account may be applied by the company subject to the provisions, if any, of its memorandum or articles of association in such manner as the company may, from time to time, determine including* -
>
> *(a) paying distributions or dividends to members;*
>
> *(b) paying up unissued shares of the company to be issued to members as fully paid bonus shares;*

> (c) *<u>any manner provided in section 37</u>[section 37 deals with the redemption and repurchase of shares];*
>
> (d) *writing off the preliminary expenses of the company; and*
>
> (e) *writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company.*
>
> *Provided that <u>no distribution or dividend</u> may be paid to members out of the share premium account unless, immediately following the date on which the distribution or dividend is proposed to be paid, the company shall be able to pay its debts as they fall due in the ordinary course of business….."*

(c). section 37(1) authorises a company (if permitted to do so by its articles) to issue redeemable shares and section 37(3) regulated the manner in which such shares may be redeemed. Section 37(3)(f) identifies four sources for payment of the redemption price. It states that "*Shares may be redeemed or purchased [a] out of profits of the company, [b] out of the share premium account or [c] out of the proceeds of a fresh issue of shares made for the purposes of the redemption or purchase or [d] in the manner provided for in subsection (5)*."

(d). section 37(3)(g) states that shares (save for treasury shares) redeemed under section 37 shall be treated as cancelled on redemption and the amount of the company's issued share capital shall be diminished by the nominal value of those shares.

(e). section 37(5)(a) states that (underlining and emphasis added) "*Subject to this section, a company limited by shares ….. may, if so authorised by its articles of association, <u>make a payment in respect of the redemption … of its own shares otherwise than out of its profits, **share premium account** or the proceeds of a fresh issue</u>*."

(f). section 37(6)(a) provides (again underlining added) that "*<u>A payment out of capital by a company for the redemption .. of its own shares</u> is not lawful unless immediately following the date on which the payment out of capital is proposed to be made the company shall be able to pay its debts as they fall due in the ordinary course of business*."

(g). section 37(6)(b) states (underlining added) that "*References in subsections (6) to (9) to payment out of capital are, subject to paragraph (f), references <u>to any payment so made</u>, whether or not it would be regarded apart from this subsection as a payment out of capital*."

107. Thirdly, the JOLs submitted that while there was a solvency test, as set out in the proviso to section 34(2), that applied to and regulated distributions and dividends paid out of the share premium account, and a solvency test as set out in section 37(6)(a) that applied to redemption payments out of capital, there was no solvency test that applied to the payment of redemption proceeds otherwise than out of capital, which included a payment out of the share premium account. The JOLs noted that the reference to "*share premium account*" in section 37(5)(a) was key and had been incorporated in 2011 as a result of an amendment to the subsection. It was clear from the Privy Council's judgment in *DD Growth* that section 37(5)(b) stipulates that "*payments out of capital*" for the purpose of the solvency test in section 37(6)(a) means payments other than those identified and listed in section 37(5)(a), which after 2011 included payments out of the share premium account. So a payment on the redemption of shares out of a share premium account was not a payment out of capital and therefore could be made even if the company was unable to pay its debts as they fell due in the ordinary course of its business immediately following the proposed date of payment. In *DD Growth,* Lord Sumption and Lord Briggs in their majority judgment had analysed the old version of section 37(5)(a) in its unamended form (so that it did not refer to the share premium account) as follows (at [35]).

> *"Beginning again with s.37(6), and leaving aside the issue about the meaning of "debts as they fall due in the ordinary course of business", there is nothing difficult or uncertain about its purpose and effect, which is to subject any payment out of capital for the redemption or purchase by a company of its own shares to the solvency test as a condition for its lawfulness. But it immediately begs the question what is "a payment out of capital". That question is answered in terms by s.37(5)(b), which is expressed to apply in the context of subss.(6)–(9). It is "any payment so made, whether or not it would be regarded apart from this subsection as a payment out of capital". It is common ground, and clearly correct, that the phrase "any payment so made" means any payment referred to in s.37(5)(a); ie "a payment in respect of the redemption or purchase of its own shares otherwise than out of its profits or the proceeds of a fresh issue of shares". Since a payment out of share premium account is plainly not a payment out of profits or out of the proceeds of a fresh issue of shares, it is deemed to be a payment out of capital, provided only that it is made "in respect of" the redemption or purchase of the company's own*

shares. It was common ground, and plainly correct, that the phrase "in respect of" is wide enough to include a payment of the premium due on the redemption of shares."

108. At [48] they noted that "*The argument for RMF was that, in the context of a progressive liberalisation of the regime for the maintenance of capital, share premium account had, from 1948 in the UK and from 1963 in the Cayman Islands, been available for the payment of a premium on redemption of shares without any requirement for commercial solvency. For completeness, it was pointed out that this has clearly been the position from 2011, when share premium account was, by further amendment of s.37(5)(a), clearly excluded from the definition of capital payments.*"

109. The JOLs argued that given that the share premium account may be used to make payments to shareholders even if the company was insolvent, it could not be said that such account formed part of the company's share capital (to which the ordinary capital maintenance rules applied). Moreover, it could not be said to be inconsistent with a shareholder's obligations under his contract of membership for him to bring a claim seeking to recover by way of damages an amount that included the sums advanced by him to the company which were credited to the share premium account.

110. The JOLs noted that Eiffel had suggested that the principles requiring and regulating the maintenance of capital existed not only to protect third party creditors of a company but also former shareholders with claims for redemption proceeds and/or members with statutory priority. However, Eiffel had cited no authority in support of this proposition. The JOLs submitted that the common law principles relating to the maintenance of capital did not extend that far. They were only concerned with the protection of creditors and not shareholders, as was made clear in *Trevor v Whitworth*.

Can and should this Court refuse to follow Houldsworth?

111. The JOLs argued that the Houldsworth Principle (formulated in the manner they had identified) was not part of Cayman Islands law. There was no existing Cayman Islands authority on the point, aside from a brief *obiter dictum* in *Re SPhinX Group* [2010 (2) CILR 1]. Further, the Houldsworth Principle was not part of either English law (as a result of legislative change) or Australian law (as a result of judicial decision).

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112. The JOLs noted that in *SPhinX,* Smellie CJ had referred to *Houldsworth* in the following terms (underlining added):

> *"Question 20 (the last in category (b)) uniquely raises an issue of potential liability of the SPhinX companies to certain investors who invested after the SMFF and PlusFunds losses were allegedly known to SPhinX management and who were not informed about those losses—in other words, potential investor misrepresentation claims. The issue raised by question 20 is therefore whether such potential misrepresentation claims should be regarded as ranking as creditor claims. No such claims have yet been brought or are any longer likely to be brought and so there is no perceived need at the moment to incur the costs of having that question answered through the court. Moreover, no such claims are likely to be brought because there appears to be an obvious answer to them.*
>
> *On the long-standing authority of the House of Lords' decision in Houldsworth…., the SPhinX companies having been placed into liquidation, an investor seeking rescission of his share purchase contract and restitutio in integrum on the grounds of misrepresentation may well no longer have available to him such remedies. For the SPhinX companies, having long since been placed in liquidation and all their assets and liabilities subject to the liquidation regime through the courts, such remedies are no longer possible. Investors must therefore resort only to such rights as their shares might afford them in the context of the liquidation of the SPhinX estates."*

113. The JOLs submitted that this statement did not amount to a binding endorsement and approval of the Houldsworth Principle (as formulated by our former Chief Justice) since the statement was made in the context of a directions hearing where the nature of the substantive issue was only brought to the Court's attention in the briefest of terms. The Court was not informed of the underlying arguments, even in summary form; the Court was neither asked nor required to make a substantive determination and it was clear that the existence of a clear principle emerging from *Houldsworth* was assumed without argument. Furthermore, the former Chief Justice's comments were *obiter dictum*.

114. The JOLs cited and relied on most of the decisions cited by Eiffel. But they drew different conclusions from the application of the principles established by those cases:

(a). first, they argued that Eiffel was seeking to establish as a common law rule in this jurisdiction a proposition that was not part of the *ratio* of *Houldsworth.* They submitted that the approach set out in *Frankland v R* did not mandate the

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application of that broader principle. The reasoning in *Frankland v R* applied to decisions of the Court of Appeal and the House of Lords of England and not to broader principles of wider application that might or might not be extrapolated from those decisions when applied to quite different facts.

(b). secondly, they argued that Eiffel's case was based on a precedent that has not been part of the English common law for almost 35 years and had been jettisoned, whatever its scope, because it was thought to be a bad rule. Where the Court was being asked to apply a principle derived from an English case, which the English Parliament had itself expressly rejected, it was difficult to see how such a decision could be treated as highly persuasive within the meaning of *Frankland v R*. It was also relevant that most other common law jurisdictions which have had cause to consider the point have clearly rejected the continued application of *Houldsworth* by one means or another (by legislation to overturn or by overruling or distinguishing the decision). Furthermore, the judgment in Houldsworth had been handed down almost 150 years ago, was given at a time when company law was in its infancy (prior even to the decision in *Salomon v Salomon*) and related to a very unusual form of company (which had started life as a partnership under the Bankers (Scotland) Act 1826 and was then re-registered as an unlimited company under the 1862 Companies Act and was governed by a deed of co-partnership).

(c). thirdly, the JOLs submitted that the Court should take into account that the common law did not speak with one voice since other leading common law courts (in particular Australia at the highest level) had rejected the argument that *Houldsworth* supported a rule that all shareholders' claims for damages for misrepresentation against a company in liquidation are barred. The JOLs submitted that Cayman Islands law will have regard to decisions of different common law jurisdictions, and will strive for a position that is consistent with rather than opposed to the laws of the other common law jurisdictions (citing *dicta* from the judgment of Lord Neuberger in *FHR European Ventures LLP v Cedar Capital Partners* [2015] AC 250 at [45]). The JOLs submitted that substantial weight should be given to the reasoning of the Justices of the High Court of Australia in *Sons of Gwalia* which could be said to pay more regard to modern business conditions and the way companies are used in commerce today.

(d). fourthly, the JOLs said that it was highly significant that the Cayman Islands had its own distinctive policies and rules so far as the maintenance of capital of companies is concerned, largely driven by the needs of the investment funds industry, which made it wrong and inappropriate to simply apply English company law decisions in this field (particularly decisions which have their foundation in the company law in England in the nineteenth century) without taking into account the particular Cayman Islands' perspective. In the language of *Frankland v R*, this was a local condition which makes it inappropriate simply to apply English case law. *Houldsworth* was decided at a time when the rules as to maintenance of capital in England were judge-made, and indeed, it could be said that *Houldsworth* itself was decided even before any rules as to the maintenance of capital had really been articulated at all because it predated *Trevor v Whitworth* by about seven years but even leaving that point aside, it was obviously not now the position that rules as to maintenance of capital are judge-made. In fact, they were almost entirely legislative and highly technical and reflect various policy considerations. This was an area of company law, the JOLs submitted, where the Cayman Islands had developed its own distinctive position that reflected the prominence and importance of the investment fund industry within the Cayman Islands and the need to take the requirements of that industry into account. While it was true that under English rules of capital maintenance priority is given to the interest of creditors over shareholders, the position in the Cayman Islands is much more nuanced reflecting the interests of investors in investment funds and it was not right to say that as a matter of Cayman Islands law the interests of creditors necessarily take priority over the interests of investors in investment funds (the JOLs cited various passages from the Privy Council's judgment in *DD Growth* to which I have referred above and below).

115. The JOLs said that while the extract from *Privy Council Practice* and from the judgment in *National Trust for the Cayman Islands* cited by Eiffel confirm, as they accept, that it is open to the Court to consider whether local conditions make it inappropriate to apply the English common law position, it was doubtful whether the approach there outlined applied in the present case. That was because in the present case the principle which Eiffel says ought to be applied on any view no longer forms of part of English law. Eiffel

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had argued that the Court ought to apply, as part of Cayman Islands law, a principle that used to form part of English law until 1989.

116. The JOLs submitted that Eiffel was wrong to suggest that a refusal by this Court to apply *Houldsworth* should be characterised as the reversal of *Houldsworth* and that such a decision was properly a matter for the Cayman legislature rather than for the Court. The JOLs argued that in fact, in view of the circumstances referred to in the previous paragraph, it was Eiffel which was asking the Court to legislate by now introducing the principle into Cayman law in order to bar potentially valid and valuable damages claims which would otherwise be available as a matter of Cayman law. Furthermore, Eiffel's floodgates argument was exaggerated and unpersuasive. Other leading common law jurisdictions (the UK, Australia, Hong Kong) allow claims such as the Misrepresentation Claims without any apparent difficulty.

117. Accordingly, this Court had a blank canvas on which to set out a rule and approach that was worked for and fitted with the local law and the needs of the financial and funds industry in this jurisdiction.

The Proof Point - discussion and decision

The core issues

118. In circumstances where the parties agree that there is no Cayman authority (or decision of the Privy Council in a Cayman appeal) that I am required to follow, to my mind the two main questions raised by the Priority Point are whether:

    (a). prior to the enactment of section 131 of the 1989 Act there was a common law rule in England based on *Houldsworth*, the subsequent authorities which discuss it and the company law authorities which delineate common law rules in related areas, to the effect that a shareholder is not entitled (a) to rescind his/her subscription contract after the commencement of the winding up and (b) therefore or in any event, to prove in a winding up for damages for misrepresentation (which induced him/her to enter the subscription contract), at all or in competition with external

(non-shareholder) creditors? I will call this supposed common law rule or proposition of law the ***no-proof proposition***.

(b). if the answer to this question is yes, so that the no-proof proposition was good law in England prior to section 131 of the 1989 Act coming into force, was and is the no-proof proposition good law in the Cayman Islands? This requires an evaluation of the reasoning in cases in other jurisdictions (in particular in Australia and Bermuda) to see whether they undermine or establish a sound basis for challenging the no-proof proposition and then whether even if it appears that the no-proof proposition was sound as a matter of English law there are reasons why it should not be applied in this jurisdiction as a result of the local considerations identified and relied on by the JOLs.

119. To answer the first question it is necessary to establish what the relevant cases decided (and whether the no-proof proposition was a necessary part of the reasoning that led to the decision – that is, was part of the *ratio* - in each case), and whether they stand as authority for the no-proof proposition (and if so in precisely what terms). To answer the second question, it is necessary to establish whether this jurisdiction in general applies common law rules to the winding up of companies and then if it does, whether the no-proof proposition is and should be one of them.

The no-proof proposition was good law in England up to 1989

120. It seems to me that when assessing whether the no-proof proposition was good law in England (based on and in light of the authorities relied on by Eiffel and the JOLs), it is necessary to consider two core issues:

(a). was there a common law rule that prohibited the return of capital otherwise than in the manner and pursuant to the procedures as authorised by statute (the ***Maintenance of Capital Rule***)?

(b). would the admission to proof of a claim for damages for misrepresentation by a person induced to subscribe for shares, where that person has not rescinded or is unable to rescind their subscription contract, give rise to a breach of the

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Maintenance of Capital Rule (or putting it another way, did the Maintenance of Capital Rule apply to such a claim for damages)?

121. Eiffel submitted that the answer to the question posed in (a) above is yes and that *Houldsworth* is one of a line of cases culminating with *Soden* that established that in England the answer to the question posed in (b) above was also yes. It seems to me that Eiffel is right on these points and I generally accept the submissions they make.

122. In my view, the starting point is the proposition that, as a matter of English law it remains a common law rule that the return of capital without statutory authority is unlawful. *Progress Property Co Ltd v Moore*, [2010] UKSC 55 and *Aveling Barford Ltd v Perion* [1989] B.C.L.C. 626 stand as authority for this proposition. In *Progress Property* at [23], Lord Walker affirmed Mummery LJ's finding in the Court of Appeal that (underlining added):

> *"The common law rule devised for the protection of the creditors of a company is well settled: a distribution of a company's assets to a shareholder, except in accordance with specific statutory procedures, such as a winding up of the company, is a return of capital, which is unlawful and ultra vires the company."*

123. There are a number of earlier authorities which establish the common law rule including *Trevor v Whitworth*. I agree with Eiffel that this is a foundational principle of English company law which remains good law despite the fact that the law governing the return of capital is now almost entirely derived from statute. I do not take the JOLs to dispute this point.

124. It seems to me to be clear that the English authorities establish that as a matter of English law, by 1989 the common law Maintenance of Capital Rule applied to any claim by a shareholder that if paid or admitted in a winding up would involve the company making a distribution out of capital to the shareholder otherwise than as permitted by the statutory rules; and that admission to proof (at least in an insolvent liquidation) of a claim by an original shareholder (who remained a shareholder in the absence of rescission) for damages for misrepresentation inducing entry into the subscription agreement was treated as such a impermissible distribution. It had been held that to permit such claims to be admitted in such a winding up would infringe the Maintenance of Capital Rule in that it would give rise to an indirect return of capital to the shareholders concerned.

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125. The principal authority that established that this was the position is *Soden* in the House of Lords (decided in 1997). Even though the claimant in *Soden* was an on-market purchaser rather a subscriber for shares, the case involved a claim for damages for misrepresentation and is a modern (indeed the most recent English) authority which views the cases from *Houldsworth* onwards through the lens of modern company law concepts and doctrines.

126. The following are the key passages from Lord Browne-Wilkinson's judgment (at page 326) that seem to me to make this good (underlining added):

> *"There is nothing in the Addlestone case to justify the application of that decision to cases where the claim against the company is founded on a misrepresentation made by the company on the purchase of existing shares from a third party. To allow proof for such a claim in competition with the general body of creditors does not either directly or indirectly produce a reduction of capital. The general body of creditors are in exactly the same position as they would have been in had the claim been wholly unrelated to shares in the company.*
>
> ………
>
> *The High Court [in Webb] held that the claim was excluded by the Houldsworth principle and held that the proposition deducible from that case was that a shareholder may not directly or indirectly receive back any part of his or her contribution to the capital save with the approval of the court. The High Court further relied on the Addlestone decision and section 360(1) but carefully delimited its application to cases of contracts to subscribe for shares. They held, 11 A.C.S.R. 731, 741 that the claim in that case "falls within the area which section 360(1)(k) seeks to regulate: the protection of creditors by maintaining the capital of the company." It is therefore quite clear that both the decision and the reasoning of the High Court were dependent upon the same factors as those in the Addlestone case, i.e. the protection of creditors from indirect reductions of capital. Those are factors relevant to cases of subscription for shares issued by the company but wholly irrelevant to purchases from third parties of already issued shares.*

127. It seems to me that this analysis is an essential part of Lord Browne-Wilkinson's reasoning. The status and admissibility of claims for misrepresentation by original shareholders, and the common law rule or principle to be derived from *Houldsworth* and *Addlestone*, were raised by the administrators and a decision on these issues, and the

reason why such claims were inadmissible, was the first step in Lord Browne-Wilkinson's reasoning as to why it was necessary to consider whether claims by secondary market purchasers fell within section 74(2)(f).

128. At page 327A-B, Lord Browne-Wilkinson said that "*All that is necessary for the decision of the present case is to demonstrate, as I have sought to do, that the decisions in Addlestone .. and Webb…. Do not apply to claims other than those relating to the issue of shares by the company*"). He decided that an action founded on a misrepresentation by a company made to a third-party purchaser of shares from a member was not based on the statutory contract between the members and the company and the members *inter se.* This was because he accepted as good law the proposition that a member who had subscribed for his shares (and thereby contributed capital) could not after the commencement of the winding up have his claim for damages for misrepresentation admitted to proof because that would result in an unlawful return of capital whereas the third party on-market purchaser had not contributed capital so that admitting his claim for damages for misrepresentation would not involve a return of capital (as Robert Walker J (as he then was) had said at first instance [1995] BCLC 686, 698-699 "*Addlestone and Webb were both claims by original members. The claimants were complaining of the very transaction under which, by becoming members, they had contributed part of the company's capital"*). As Lord Browne-Wilkinson said at page 327, "*All that is necessary for the decision of the present case is to demonstrate, as I have sought to do, that the decisions in Addlestone, 37 Ch.D. 191 and Webb, 11 A.C.S.R. 731 do not apply to claims other than those relating to the issue of shares by the company."* I note that leading counsel for the administrators of Atlantic, Robin Potts QC, had argued both in the Court of Appeal and in the House of Lords that (as was summarised in the judgment of Peter Gibson LJ at page 315) "*the common denominator which requires postponement of misrepresentation claims by transferees and subscribers alike lies in the basic principles as to maintenance of capital*" and that in his judgment in the Court of Appeal Lord Justice Peter Gibson had said (at page 316) that:

> *"We of course accept that the underlying rationale of section 74(2)(f) is the principle of the maintenance of capital or the principle that members come last; but whilst we are wholly in sympathy with those principles, the legislature has chosen not to give universal application to them. In contrast with the position of a partner in partnership law, the legislature has imposed limiting conditions by*

requiring the sum due to the member to be so due in his character of a member by way of dividends, profits or otherwise."

129. I agree with Eiffel that even if Lord Browne-Wilkinson's analysis of the reasons for the inadmissibility of misrepresentation claims by non-rescinding original shareholders, and of *Houldsworth* and *Addlestone* (and *Webb*, which I discuss below) was only *obiter,* it remains of great persuasive authority and shows what the position was in English law at the time that the decision was handed down. This is not only because of the expertise in company and insolvency law of Lord Browne-Wilkinson (and the other members of the panel who sat on the case which included Lord Hoffmann) but also because, as I have mentioned, of the scope of the argument before their Lordships and because the judgment is based on an updated and modern conception of the key company law doctrines in issue.

130. I broadly accept Eiffel's submissions as to the proper approach to interpreting *Houldsworth*, *Addlestone* and the subsequent English cases leading up to *Soden*.

131. It is undeniable that the facts in *Houldsworth* are distinguishable from those of this case, that it was decided in the context of shareholders as partners in unlimited companies having a liability to contribute and at an early stage in the development of the concepts of corporate capital, corporate personality and the Maintenance of Capital Rule. But *Houldsworth* was one of a number of cases in the 1880s and 1890s (including *Tennent*, *Addlestone*, *Trevor v Whitworth*, *Ooregum* and *Salomon v Salomon*) which together settled the common law rules relating to these core concepts and together stand as authority for the no-proof proposition (I discuss below the issues concerning the precise formulation of that proposition).

132. The reasoning of their Lordships in *Houldsworth* focussed primarily on the fact that Mr Houldsworth was a member of an unlimited company with a continuing liability to contribute and that he could not throw that liability on his co-contributors and co-obligors (those co-obligors were the focus of the concern and not the external creditors who would in any event be paid by the other contributories). The House of Lords rejected the submission that there was no inconsistency between the claim for damages and remaining a partner and contributory. Earl Cairns thought that the inconstancy arose because Mr Houldsworth had agreed that the assets of the company should be applied in paying its

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antecedent debts and liabilities and not liabilities owed to him as a result of his acquisition of his shares. Lord Selborne, who spent a good part of his judgment dealing with the attribution issue (Mr Houldsworth had argued that since a principal was liable for the fraud of his agent acting within the sphere of his business, even where the principal was an incorporated company acting through its directors, prior to liquidation the Bank was liable in respect of the fraud of the directors to compensate him for his loss), thought that while Mr Houldsworth remained a shareholder the question of whether he could claim was an issue as between the members and it could not be right that he could "*throw upon them [his] share of the corporate debts and liabilities [of the Bank].*" Lord Hatherley took a similar view ("*In truth [Mr Houldsworth] is trying to reconcile two inconsistent positions, namely, that of shareholder and that of creditor of the whole body of shareholders including himself….no case can be adduced in which a person so claiming to be a shareholder has at the same time successfully asserted his claim against a company in liquidation for such a debt as this, namely one in which he is himself a co-debtor with all his fellow shareholders to himself, and is himself in common with them responsible again to them individually for like liabilities irrespective of representations made by their common agent.*"). Lord Blackburn considered that the issues were "*ruled by the decision of the House [of Lords] in Addie v The Western Bank*" (in which a claim in deceit by a partner/shareholder against a bank operating as a co-partnership in had been dismissed where the bank had been registered and incorporated as a joint stock company after the partner/shareholder had acquired his shares on the ground, *per* the Lord Chancellor, that the company could not be sued for frauds committed by the directors before incorporation).

133. But as Lord Justice Peter Gibson said in the Court of Appeal in *Soden* (at page 310 F-H):

> "*Mr. Potts [for the administrators] acknowledged that [the] decision* in Houldsworth *lacks the clarity and sophistication of later judgments, but he rightly submitted that the ratio of the case and the policy underlying the ratio were relatively clear, viz. a member is precluded from bringing an action for damages for deceit arising out of a contract for the subscription for shares without first rescinding his contract of membership. It was in substance a case of approbating and reprobating, which, Earl Cairns L.C., said was not permitted.*"

134. The importance of the inconsistency point was also highlighted by Lord Justice Lindley in his formulation in *Addlestone* of the principle on which the decision in *Houldsworth*

was based. But in *Addlestone,* the inconsistency was not simply between a shareholder having an *outstanding* liability to contribute to the capital of a company at the same time as (while still a shareholder) seeking damages for the loss suffered as a result of becoming a member payable out of the company's capital in competition with creditors. In *Addlestone,* the shareholders who held shares (in a limited company) issued at a discount had paid the calls made on them. Having done so, they then sought leave to prove as a creditor "*for breach of contract or otherwise in respect of the shares*." There was therefore no outstanding liability owed by the shareholders. As Lord Browne-Wilkinson said in *Soden* (at page 325F-G), there was some doubt about the cause of action relied on by the claimant shareholders but in his view the claim must have been for breach of (or related to) the statutory contract between the members and the company. The inconsistency, as Lindley LJ said, was between remaining a shareholder and claiming back, directly or indirectly, any part of the sums paid over as capital. And as Lord Browne-Wilkinson said in *Soden* (in the context of the capacity in which the claims for damages were being made) "*the principle must apply equally to negative claims; claims based upon having paid money to the company under the statutory contract which the member says that he is entitled to have refunded by way of compensation for misrepresentation or breach of contract*." Kay J (at page 200), Cotton LJ (at page 204-205), Lindley LJ (at page 206) all explained *Houldsworth* on the basis that Mr Houldsworth was impermissibly seeking to circumvent and avoid his responsibility as a shareholder to contribute capital to the Bank and therefore had no right to prove in the winding up.

135. As Mr Millett KC put it in his submissions on *Addlestone* (day 2 transcript at page 13):

> "*… contribution to capital has two facets. There is the liability to pay for your shares in the first place and the concomitant prohibition on your having payment back after a winding-up whilst remaining a shareholder. That we say is plain from Trevor v. Whitworth. In fact, it is the case before a winding-up, too, but, because a winding-up wholly alters the position and the obligations of creditors intrude, it becomes even more important. To put it in a nutshell, you cannot claim while remaining a member, because you remain liable to contribute and, if you have got your money back, you still remain liable to contribute it, so the money would have to go back in again. Or you will have received your shares and nil paid, unlike other shareholders, or at a discount of 100 per cent, which is the same thing*."

136. It also seems to me that the understanding and scope of the Maintenance of Capital Rule I have outlined above is supported by the decisions of Mr Justice Harman and the Court of Appeal in a case related to *Soden*. This is *Barclays Bank plc v British and Commonwealth Holdings plc* [1995] BCC 19 and 1059 (admittedly a case not cited by the parties but one which it seems permissible to refer to as emphasising reasoning in cases which were cited). It is true that the case is distinguishable from the facts of this case since it did not involve a claim for damages for misrepresentations made by the company but instead a claim by redeemable preference shareholders for breach of a contract to pay the redemption price of the shares if the company failed to do so and then a claim against the company by the third parties (so that the preference shareholders who were paid had, assuming that they had not exercised their right to redeem before the winding up, no cause of action which could constitute them as creditors and potentially entitle them to separate treatment from that of other preference shareholders). Nonetheless, the case illustrates how the Maintenance of Capital Rule applies broadly and covers claims to prove in the winding up which can be characterised as giving rise to an indirect return of capital and the unjustifiable elevation of the rights of shareholders to the claims of creditors. The basis for the decision is neatly described in Ferran, Howell and Steffek's *Corporate Finance Law and Practice* (3rd. ed., OUP, 2023 at page 208):

> *"An indirect return of capital was .. in issue in Barclays Bank plc v British and Commonwealth Holdings plc where a group of banks ..was required to buy a company's redeemable preference shares in the event of the company failing to redeem those shares in accordance with their terms. The company gave financial covenants to the banks so that if it found itself unable to redeem its preference shares it would also be in breach of [the contract with] the banks. The economic effect of the arrangement was that the banks had to pay for the shares but could then prove in the company's liquidation as creditors for the amount that they had paid for the shares as the sum due for breach of contract. This arrangement was held to amount to an indirect return of capital, contrary to Trevor v Whitworth, on the basis that the rule in that case was wide enough to catch an agreement which was only likely to be called upon in the event of the company's insolvency and which enabled shareholders in that event to obtain from third parties a payment in an equivalent amount to the payment due from the company and for the third parties thereupon to become entitled as creditors to seek repayment from the company. Had the decision been otherwise, the effect would have been to allow a claim by one group of shareholders to be converted into a claim ranking before general shareholders' claims and equally with other creditors."*

137. As Harman J said at page 28:

> *"….[this] leads to the conclusion that any agreement which is only likely to be called upon if the company has no distributable profits and which will, if called upon when the company becomes insolvent, have the effect of increasing the liabilities of a company, by substituting, for rights which are rights held by shareholders ranking behind creditors, rights held by a creditor ranking equally with other creditors, is objectionable by reason of the rule in Trevor v Whitworth . It is clear that, upon the footings stated in the special case, the effect of the three stages: (a) the exercise by Caledonia of its put options against Tindalk, (b) the obligation of the plaintiff banks to fund Tindalk's liabilities to pay Caledonia, and (c) the breach of the covenants given by B & C to the plaintiff banks, leads in combination to the rights of Caledonia as a preference shareholder to have its preference shares redeemed, which rights are an obligation of B & C to one of its members and as such ranking behind its obligations to unsecured creditors, being substituted, in effect, by the rights of the plaintiff banks ranking as unsecured creditors equally with other such creditors against B & C."*

138. At [7] of their reply skeleton, the JOLs said that "*In essence, the point is that there is an inconsistency between a shareholder being, on the one hand, under an obligation to contribute to the assets of the company in liquidation and, on the other hand, being able to assert a damages claim for misrepresentation against the company in connection with his subscription for shares. This is particularly so where, as in the case of an unlimited company or where all the shares were issued as partly paid, the other shareholders would have fund the monies paid to the claiming shareholder in respect of his damages claim*." For the reasons I have given, it seems to me that the JOLs' submission, to the extent that it went this far, that the decisions in *Houldsworth* and *Addlestone* can and should be confined to cases of unlimited companies or of shares which at the commencement of the winding up were not fully paid or which were subject to an outstanding liability to make a contribution to the company's capital, should be rejected.

The no-rescission following winding up rule – does it apply when the company is or becomes solvent?

139. It is an important part of Eiffel's case that the Misrepresentation Claimants remain shareholders as a result of their being unable to rescind their subscription agreements. The JOLs did not challenge the proposition that the Misrepresentation Claimants' right to rescind their subscription contracts was lost and terminated on the commencement of the winding up. As I have already noted, the point had been conceded (and said to have been rightly conceded) in *Houldsworth* and has been held to be correct in a number of the subsequent cases.

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140. I must therefore decide this case on the basis that the Misrepresentation Claimants' right to rescind was lost on the commencement of DLIFF's winding up. However, since Justice Doyle has given leave to appeal his judgment so that at least the HQP case is going up to the Court of Appeal (and may possibly be appealed further), it seems to me to be appropriate to record a reservation I have on this point. It seems to me to be at least arguable that since the right to rescind is barred on winding up because of the intervention of third party rights the winding up order should only preclude rescission having effects as against those third parties (the third party rights are the rights of creditors and possibly shareholders to a distribution in accordance with the statutory scheme imposed by the Companies Act - as was held in *Ayerst (Inspector of Taxes) v C. & K. (Construction) Ltd* (1976) AC 167 the effect of a winding up order is to divest the company of the beneficial ownership of its assets since it can no longer use them for its own benefit and they must be distributed in accordance with the statutory scheme).

141. During the hearing, I referred Mr Millet KC and Mr Smith KC to the discussion of *Houldsworth* and this rescission point in O'Sullivan, Elliott and Zakrzewski (***O'Sullivan***), *The Law of Rescission* (3rd ed., 2023, OUP) at [25.21] - [25.78]. I explained that I considered this to be the most detailed, up to date and useful discussion of the issues that arise in the case in any of the available textbooks. I invited them to review the analysis adopted by O'Sullivan and make any submissions on it that they wished to make.

142. Mr Millett KC during his oral submissions referred to certain of the passages from chapter 25 in O'Sullivan (in particular [25.36] and [25.60]) dealing with winding up as a bar to shareholder's rescission (it is worth adding that it seems to me that the discussion of *Houldsworth* and the subsequent cases in O'Sullivan support Eiffel's position and the analysis and approach I have set out above – see in particular [25.49] where it is said, under the heading "*Bringing a damages claim*" and after referring to *Houldsworth,* that "*Today the rule is explained in terms of protecting creditors from an unauthorised return of capital*" citing in footnote 81 *Webb* and *Soden* as well as *Johnson v McGrath* (2005) 195 FLR 101 and *Cadence Asset Management v Concept Sports* (2005) 147 FCR 434 at 446).

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143. O'Sullivan considers the question of whether the right to rescind is lost even where the company is solvent and says this (at [25.59]-[25.60]):

> *"25.59 The bar applies where the assets of the company are sufficient to pay creditors and the costs of the winding up, at least when rescission is sought for the purpose of avoiding liability as a contributory. That is because the statutory obligation to contribute extends to the payment of such sums as are necessary to adjust the rights of contributories among themselves.*
>
> *25.60. The position is probably the same if the shareholder wishes to rescind in order to recover the price paid for shares. There are comments obiter in [Stone v City and County Bank (1877) 3 CPD 282 (CA) (**Stone**) at page 298-299 although O'Sullivan says at 295] that might suggest rescission would be permitted if at the time of repudiation, no debts to the company remain unpaid. But it is unlikely that this approach would be followed. Even if the company is solvent, rescission permits a shareholder to become a creditor and thereby to obtain priority over other shareholders and [Burgess's case] decided [see pages 512-513] that the bar was intended to protect creditors and shareholders alike."*

144. O'Sullivan concludes that there is at least a suggestion in the old cases that rescission might be allowed where and once the company's creditors have been paid (see Brett LJ at page 311 and Cotton LJ at pages 313-314 in *Stone*) but that *Burgess' Case* is authority for the bar on rescission is absolute. In *Burgess' Case* Mr Burgess had argued that that he was still entitled to rescind his subscription contract because the company was solvent and that all that was decided in *Oakes* was that a shareholder was not entitled to rescind if there were creditors to be paid and that Bramwell L.J. in *Stone* had treated *Oakes* as having been decided on the principle that the power to rescind a contract was gone because the rights of creditors were to be adjusted. Jessel MR (see in particular at pages 512-513) held that Mr Burgess' claim failed. O'Sullivan (at [25.37]) accurately summarises the Master of the Rolls' reasoning as follows: "*the rights of shareholders as co-contributories were also to be protected on winding up. Rescission was therefore barred even if the creditors could all be paid in full, because it would have the effect of increasing the contribution from the remaining shareholders*." But O'Sullivan goes on to note (at [25.38]) that the Supreme Court of Canada has held that the reason for the bar on rescission is that the winding up creates an entirely new situation by altering relations not only between the creditors and shareholders but also between the shareholders *inter se* (*Re Northwestern Trust Co* [1926] SCR 412 at 419) and that Dixon J had taken a

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similar view in *Southern British National Trust Ltd v Pither* (1937) 57 CLR 114 which had been cited with approval by Crennan J in *Sons of Gwalia* at [270].

145. It is not clear to me that the Master of the Rolls' reasoning in *Burgess' Case* (which depends on the prejudice to other contributories of allowing rescission even after creditors have been paid in full because of the statutory power to adjust the right of contributories) would be applied today in a case involving fully paid up shares and in a case where there is no basis for an adjustment of the rights of contributories. Furthermore, and importantly, it is as least arguable that in the modern era the bar on rescission arising from the intervention of third parties (such as bona fide purchasers for value without notice) is not absolute. Instead the bar only operates to preclude rescission having effects as against those third parties: see *Independent Trustee Services Ltd v GP Noble Trustees Ltd* [2013] Ch. 91 at [50], Jordan English, *Deeds, Rescission and Restitution* [2023] L.Q.R. 2023at 363-368 and O'Sullivan at [20.23]. Allowing rescission at the point at which all creditors had been paid would, it might be said, be consistent with the underlying rationale, as explained above, for disallowing damages claims for misrepresentation by shareholders, namely the need to preserve the capital of the company when it is needed on a winding up to pay those with a prior ranking interest in the company, namely its creditors.

146. Justice Gummow discussed the basis for the no rescission rule in his judgment in *Sons of Gwalia* (I consider his analysis of the Houldsworth Principle below) and noted that some of the explanations given in the older cases were no longer sustainable (see [55]-[57]). He concluded, somewhat inconclusively, as follows (underlining added):

> *"58. Thirdly, however, in administering an equitable remedy such as that of rescission, it is proper to take into account both the supervening, albeit indirect, interests of the shareholders and creditors referred to by Isaacs J in Blyth, <u>and the changes brought about in the enjoyment of the rights of shareholders and creditors by the administration required by a winding up, even where the claims of creditors will be satisfied. It is in this context that one may agree with the view of Dixon J in Southern British National Trust Ltd v Pither that the denial of equitable relief to rescind the contract of membership after winding up was inevitable</u>.*
>
> *59. <u>However, it is difficult in this area to state propositions in absolute terms</u>. Shortly after Pither, in Elder's Trustee and Executor Co Ltd v Commonwealth Homes and Investment Co Ltd, Rich ACJ, Dixon and*

McTiernan JJ held that the plaintiff was entitled to an order for rectification of the register of members and stayed an order for repayment of subscription moneys with interest to enable the plaintiff to prove in the winding up of the company for those moneys. The proceedings had been instituted six weeks before the lodgement of the winding-up petition, but at a time when the company was in a hopeless financial position.

60. Whatever be the basis in principle for the rescission cases, they do not dictate any particular conclusion respecting the denial in Houldsworth of the existence of any remedy in damages. Something more now should be said respecting that case."

147. Justice Gummow therefore doubted that a right to rescind could continue after the significant changes brought about by the commencement of a winding up to the rights of creditors and shareholders and of the company in respect of its assets, but he acknowledged that there might be exceptions or qualifications to the absolute bar. But because he considered that the inability to rescind did not affect Mr Margaretic's right to claim and prove for damages or compensation under the applicable statutes there was no need to take the analysis further.

A common law rule that applies to the statutory regime for proving in a winding up?

148. In my view it is clear that a common law rule can affect and qualify a creditor's right to prove in a winding up so that it is wrong to say that the no-proof proposition cannot be regarded as good law because it is inconsistent with the statutory statement in section 139 of the Companies Act of what is provable. I do not regard the approach of the majority Justices of the High Court of Australia in *Sons of Gwalia*, in which they appear to regard all issues affecting the right to prove as being a bare matter of statutory interpretation, as consistent with the English cases, whose approach seems to me to be the right one.

149. The proper approach was set out by Lord Neuberger in *Re Lehman Brothers International (Europe) (In Administration)* his judgment in [2018] AC 465 at [13] as follows:

"Further, despite its lengthy and detailed provisions, the 1986 legislation does not constitute a complete insolvency code. Certain long-established Judge-made rules, albeit developed at a time when the insolvency legislation was far less detailed, indeed by modern standards sometimes positively exiguous, nonetheless survive. Recently invoked examples include the anti-deprivation principle (see Perpetual

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Trustee Co Ltd v BNY Corporate Trustee Services Ltd [2012] 1 AC 383), the rule against double-proof (discussed in In re Kaupthing Singer & Friedlander Ltd (in administration) (No 2) [2012] 1 AC 804, paras 8 to 12), the rule in Cherry v Boultbee (1839) 4 My & Cr 442 (also discussed in Kaupthing (No 2) [2012] 1 AC 804, paras 13 to 20), and certain rules of fairness (alluded to in In re Nortel GmbH [2014] AC 209, para 122). Provided that a Judge-made rule is well-established, consistent with the terms and underlying principles of current legislative provisions, and reasonably necessary to achieve justice, it continues to apply. And, as Judge made rules are ultimately part of the common law, there is no reason in principle why they cannot be developed, or indeed why new rules cannot be formulated. However, particularly in the light of the full and detailed nature of the current insolvency legislation and the need for certainty, any judge should think long and hard before extending or adapting an existing rule, and, even more, before formulating a new rule."

150. Accordingly, the common law can establish a gloss on and overlay the statutory rules where it is consistent with the statutory regime. The no-proof proposition is consistent with the Companies Act in so far as it gives effect to a core policy of the companies legislation, being the Maintenance of Capital Rule (subject to my analysis below as to impact of the rules regulating the payment of the redemption price from the share premium account). Furthermore, section 139 does not purport to deal with whether particular causes of action entitle a creditor to prove. It stipulates that all liabilities that are otherwise properly admissible are provable whatever their legal character (for example whether they are certain or contingent, present or future).

The formulation of the no-proof proposition – is it absolute or qualified and how does it relate to the statutory subordination effected by section 49(g)?

151. The question arises as to whether, since the justification and rationale for the no-proof proposition is the Maintenance of Capital Rule, and the need to ensure that the company's capital is maintained for the benefit of creditors, the no-proof proposition should operate only as a ranking rule prohibiting the admission to proof of a damages claim in competition with and until payment in full of all external creditors. This question raises the further issue of the relationship between the common law rule (the no-proof proposition) and the statutory subordination of sums due to members in their character as a member effected by section 49(g). I shall consider section 49(g) in greater detail when discussing the Priority Point but it needs to be reviewed in this context to assess whether it throws any light on the proper formulation and operation of the common law rule.

152. If the Misrepresentation Claims are admissible but within and subject to section 49(g) then the right of the Misrepresentation Claimants to prove is suspended and subject to the no-competition principle. There is a qualified rather than an absolute prohibition designed to ensure that the rights of members as members come last and the right of creditors to have first recourse to capital is preserved (i.e. to give effect to the Capital Maintenance Rule). It might be said to follow that since section 49(g) gives effect to and ensures respect for the Capital Maintenance Rule, there is no need for a separate common law rule (the no-proof proposition) if damages claims by shareholders in deceit for their loss are within the sub-section (or at least there is no need for an absolute bar on the admission to proof of such claims), so that cases can be decided solely by reference to and in reliance on the statutory subordination provisions (what I will label the "***no need for an absolute bar principle***").

153. Section 49(g) is in the following terms (underlying added):

> *"no sum due to any member of a company in that person's character of a member by way of dividends, profits or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between that person and any other creditor not being a member of the company; but any such sum may be taken into account for the purposes of the final adjustment of the rights of the contributions amongst themselves."*

154. Section 49(g) is in substantially the same terms as the original enactment giving effect to the statutory subordination, namely section 38 of the UK's Companies Act 1862 (which was enacted and in force before *Houldsworth*). This provided that (underlying added):

> *"No sum due to any member of a company, in his character of a member, by way of dividends, profits, or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between himself and any other creditor not being a member of the company; but any such sum may be taken into account, for the purposes of the final adjustment of the rights of the contributories amongst themselves."*

155. Section 74(2)(f) of the UK's Insolvency Act 1986, which was considered by the House of Lords in *Soden*, is in similar terms (underlining added):

> *"(1) When a company is wound up, every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and*

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liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories among themselves.

(2) This is subject as follows . . . (f) a sum due to any member of the company (in his character of a member) by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves."

156. The Australia statutory provision, section 563A of the 2001 Act, which was considered by the High Court in *Sons of Gwalia* (and which I discuss further below) was drafted in different terms:

> *"Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied."*

157. In *Sons of Gwalia,* Justice Hayne commented on the effect of section 38(7) on the right to prove (and it seems to me that his approach properly sets out the effect of section 49(g)). He said that (at [151]) (underlining added):

> *"The second aspect of note about s 38(7) is that it spoke of a "sum due to any member of a company, in his character of a member". It said that no sum of that kind "shall be deemed to be a debt of the company, payable to such member in a case of competition between himself and any other creditor not being a member of the company". In modern terms it was a provision that is best understood, when applied in an insolvent winding up, as regulating the ability of a member to prove in the winding up rather than as a provision regulating priority of payment. If the company was insolvent there would inevitably be competition between the member and other creditors, and the sum due to a member "in his character of a member" was not to be deemed to be a debt. Only if the company was solvent could there be no competition of the kind identified and only then could there be any "final adjustment of the rights of the contributories amongst themselves."*

158. It appears that the interrelationship between the common law rule and the statutory subordination provision was somewhat confused in the judgment of, or at least not clearly dealt with by, the Justices of the High Court in *Webb*.

159. They noted that Tadgell J in the Appeal Division of the Supreme Court of Victoria had "*concluded that the principle in Houldsworth received statutory recognition in [section*

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360(1) of the Companies (Victoria) Code]" and held that this conclusion was correct and that "*it draws support from the provisions of 360(1)(k).*" As I have also already noted, Section 360(1)(k) is similar in all material respects to section 49(g) of the Companies Act. Tadgell J had not considered the relationship between the statutory subordination of members' claims arising under section 360(1)(k) and the no-proof proposition since, as he said at page 631 lines 20-23, there was no need for him to do so as he had decided (in answering question (b) in the affirmative) that the non-withdrawable shareholders were precluded from bringing an action in damages. They had no provable claim. His focus was on section 360(1) which is equivalent to the preamble or chapeau of section 49 (every member is liable to contribute to the property of the company an amount sufficient for the payment of its debts and liabilities) and the limitation in section 360(e) in the case of limited companies to the amount unpaid on shares. The High Court dismissed the appeal but appear to have decided the case on the basis of section 360(1)(k) and that the shareholders had no claim *which could prevail against the claims of creditors* (see the headnote on page 396 and the conclusion of the judgment of the majority at page 411).

160. Chief Justice Gleeson in *Sons of Gwalia* pointed out that the view that *Houldsworth* could be seen as having received a legislative indorsement gave rise to a "*chronological curiosity*" because the language of section 360(1)(k) reflected that in section 38(7) of the 1862 Act which predated *Houldsworth* and he noted (at page 473) the apparent confusion in the Justice's judgment in *Webb* between a denial and a postponement or subordination of a claim. If, as Tadgell J had held, the claim was precluded then "*section 360(1)(k) would not have applied.*" Chief Justice Gleeson concluded (see [16] at page 473i and [24]-[26]), in my view rightly, that the High Court in *Webb* must be taken to have decided the case on the basis of section 360(1)(k) although they considered that "*some of the considerations underlying Houldsworth [were] relevant to the interpretation of section 360(1)(k) operating in addition to the Code.*" Gleeson CJ considered that (see [28]) for the purposes of section 360(1)(k) (and as a matter of the proper construction of the section) it was necessary to have regard to nature of the claim being made rather than its economic effect (on creditors). It was therefore insufficient to look to the rationale for the Houldsworth Principle (the Capital Maintenance Rule) and treat any claim which was economically equivalent to a return of capital as being a debt owed to the claimant in his/her capacity of member. In any event, Mr Margaretic did not seek to recover paid up capital and his claim was not founded on any rights he obtained or obligations he incurred

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by virtue of his membership of the company. He also noted (at [12]) that the fact that section 360(1)(k), like section 49(g), stated that the member's claim was not to be treated as a debt in a case of competition between a member-creditor and other creditors "*might account for some elision of the issue whether a debt is provable and the issue of ranking in terms of priorities*" (however section 563A, the section that was to be applied in *Sons of Gwalia*, did clearly distinguish those issues and assumed that a certain debt was provable in the winding up).

161. The other Justices of the High Court sitting in *Sons of Gwalia* also considered that the proper construction of section 563A did not depend on and was not affected by (and that the construction of section 360(1)(k) in *Webb* should probably not have depended on) any judge-made law in general and the Houldsworth Principle in particular (see for example the judgment of Justice Hayne at [136], [148], [185] and [192], Gummow J at [86] and Kirby at [114]). Kirby J (at [110]-[111]) considered that, although tempting, section 563A of the 2001 Act was not to be interpreted, as the Justices in *Webb* were taken to have done in relation to section 360(1)(k), by reference to the "*presumed general policy of the 2001 Act*." Justice Gummow considered that, because of the chronology, the Houldsworth Principle had nothing to do with section 360(1)(k), based as it was on section 38(7) although there appears to have been only a limited discussion, in the judgment of Hayne J, as to the reason for the enactment of section 38(7) in 1862. It is unclear how Justice Gummow could safely conclude that this subsection had a purpose that was distinct from the rationale for the Houldsworth Principle even if, as he thought, that principle represented a subsequent rationalisation of the decision on *Houldsworth* in light of the "*developing doctrine applicable to company law*". Hayne J considered (at [184]) that "*decisions after Houldsworth especially [Addlestone] explained Houldsworth as depending upon the application of section 38(7) of the 1862 Act*" and (at [187]) that it was "*Not until Addlestone that there was any attempt to relate the conclusion in Houldsworth to relevant provisions of the 1862 Act*" (for the reasons set out above, this view of *Addlestone* seems to me to be wrong).

162. Lord Browne-Wilkinson in *Soden* clearly did not think that the existence of section 74(2)(f) (and before that of section 38(7)) of itself obviated the need for and was a basis for rejecting as good law the no-proof proposition, although the point was not argued.

163. I must say that I see the force of the no need for an absolute bar principle and for saying that there is no need for a common law rule that imposes an absolute and permanent prohibition on the right of the Misrepresentation Claimants to prove. Rather it imposes a qualified bar and works alongside and supports the regime established by section 49(g).

164. This is because (a) on the basis that a broad construction of section 49(g) is justifiable so that the Misrepresentation Claims are treated as subject thereto and (b) the relative ranking between the Misrepresentation Claims which will be admitted to proof once all external creditors had been paid, and the rights of shareholders to a distribution, is appropriate and justifiable.

165. As regards (a), in my view, as I explain below, the broad approach to the construction of section 74(2)(f) taken by Lord Browne-Wilkinson in *Soden* is justifiable and should be applied to section 49(g).

166. As regards (b), I discuss further below the ranking of the Misrepresentation Claims, assuming that they are provable after non-member creditors have been paid in full. If the no-proof proposition is treated as only applying up to the point at which non-member creditors have been paid in full (or possibly provided for) then it would be a common law rule that supplemented and supported the regime established by sections 49(g) and section 37(7) of the Companies Act (the statutory regime now sets out the primary rules with the common law rule a secondary rule which is operative where the statutory regime is unclear or incomplete). The Misrepresentation Claimants could prove in the winding up but on a basis which respected the Maintenance of Capital Rule and was entirely consistent with the relevant provisions in the Companies Act which are designed to preserve the rights of non-member creditors to prevent claims by shareholders as members from having prior access to the company's capital.

167. It does not seem to me that allowing holders of redeemable shares to prove in the winding up for damages for misrepresentation unfairly or improperly prejudices the position of other holders of redeemable shares or shareholders (and therefore the rights and position of other shareholders does not require or justify treating the no-proof proposition as resulting in an absolute bar on the right to prove). It does seem to me that the Capital Maintenance Rule is designed primarily to protect creditors rather than members albeit

that shareholders have an interest in ensuring that the company's capital is maintained so that it can discharge its liabilities and conduct its business. But allowing the Misrepresentation Claimants to prove for damages in deceit after non-member creditors have been paid recognises that they are (also) creditors with a monetary claim against the company who are entitled to rank ahead of shareholders (who have no such claims). As between the shareholders *inter se* the redeemable shareholders with misrepresentation claims are, at common law, entitled to be treated as creditors and have priority. The only limitation, which the reasoning in *Houldsworth* and progeny developed and spelt out, is that such shareholders with misrepresentation claims cannot claim as creditors in competition with non-member creditors when such claims involve in substance a return of the capital. It is true that on this approach the Misrepresentation Claimants are entitled to prove while they retain their shares but this does not prejudice the other shareholders because the Misrepresentation Claimants have to bring into account and reduce their claim by the value of the shares they retain. There is therefore no question of double-recovery to the prejudice of the other shareholders (which would occur if the Misrepresentation Claimants could prove for their loss without giving credit for the value of the shares which they retain). Of course, the relative ranking of the monetary claims of holders of redeemable shares with rights under section 37(7), redemption creditors and with misrepresentation claims is also and primarily governed by section 37(7) and section 49(g) of the Companies Act, which I discuss in detail below.

168. I appreciate that, as I have explained, this approach has not been adopted in the English case law and that it is inconsistent with the decision in *Addlestone* where the preference shareholders were held to have no right to prove. It might also be said to be inconsistent with the cases on the "no recission following the winding up" rule which reject the argument that the right to rescind should revive after all external creditors have been paid and the company is solvent. Furthermore, I can see that it can also be argued that since the statutory regime also provides for the subordination of the Misrepresentation Claims to non-member creditors it pre-empts and obviates the need for the common law rule. However, because it has never been held that the statutory subordination that started with section 38(7) of the 1862 Act has that effect, and because I can see that there may be benefits in retaining a consistent common law rule alongside the statutory regime, I have concluded that the preferable approach is to treat the no-proof principle as good law in the formulation I have set out (which seems to me to reflect, as I have explained, the

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underlying reasoning in the cases and the underlying policy and to present a rational and integrated view of the law in this area).

The Australian authorities

169. I do not regard the reasoning in *Webb* or *Sons of Gwalia* as requiring or justifying a different approach to that which I have derived from the English cases.

170. *Webb* supports the view that the Houldsworth Principle is sound and good law and is to be regarded as based on and as giving effect to the Capital Maintenance Rule. It also, in my view rightly, recognises that there is a close relationship between the common law rule and the statutory regime although the High Court's reasoning on this is not, as I have explained, as explicit and clear as it could have been. The Justices in *Sons of Gwalia* were primarily motivated by the need to give effect to the important statutory right to compensation and statutory investor protection regime and considered that the case before them had to be decided by reference to that statutory regime and that created by the 2001 Act alone without reference to (and without being read down by reliance on) old common law rules derived from English law. They were not prepared to undermine the statutory right by giving section 563A a wide construction when that section did not explicitly provide for that result. What they did say on the Houldsworth Principle, save for Justice Gummow (whose final conclusion on the Houldsworth Principle is not clear), also supports the view that it is to be regarded as based on and as giving effect to the Capital Maintenance Rule.

171. Following but keeping in mind these general remarks, I shall make some comments on the judgments in *Webb* and *Sons of Gwalia*.

Webb

172. The reasoning in the Appeal Division and the High Court in *Webb* supports the view that *Houldsworth* and the subsequent cases are authority for the no-proof proposition and that the rationale for this common law principle is the Maintenance of Capital Rule (as Lord Browne-Wilkinson noted in *Soden* at page 326 in the passage which I have already referred to and cited).

173. In *Webb,* Mason C.J., Deane, Dawson and Toohey JJ. said [1993] 4 LRC 395 at 407-408 said this (underlining added):

> "*The statutory provisions authorising the return of capital are not inconsistent with the Houldsworth proposition. Indeed, they proceed on an acceptance of part of the reasoning which underpinned the decision in that case. They permit a return of capital to shareholders when it is established to the satisfaction of the court that the return of capital will not prejudice the interests of creditors or when it is consented to by creditors [I would note that this formulation of the Houldsworth Principle lends support to the approach I have set out above and to the no need for an absolute bar principle]. Hence the statutory provisions treat the subscribed capital as protection to creditors and accept that the capital should not be returned directly to shareholders otherwise than pursuant to a permissible return of capital……. But, in the present case, the members seek to prove in the liquidation damages which amount to the purchase price of their shares, which is a sum directly related to their shareholding.*"

174. As I have already noted, I accept that *Webb* is to be treated as a case deciding an issue concerning ranking and not the right to prove. As the majority noted (at page 406h-i) the critical question in the case related not to whether the decision in *Houldsworth* to bar Mr Houldsworth's proof was right but rather the proper construction of the relevant statutory provision, namely section 360(1)(k), and whether the section should be understood as embodying the same rationale and principle and seeking to achieve the same effect as the decision in *Houldsworth*. The Justices were clear in this context that the rationale and principle underlying the decision in *Houldsworth* was the common law Maintenance of Capital Rule.

Sons of Gwalia

175. It seems to me that Eiffel's analysis of *Sons of Gwalia* is broadly correct.

176. As Justice Heydon confirmed at [263] and [264] (quoted above), the issue in the case concerned the ranking and not the admissibility of the claim. While there had been a challenge to the admissibility of the claim by ING this appears to have been half hearted. As Justice Heydon pointed out it appears that ING had abandoned the point by the end of oral submissions. This may explain why the *Houldsworth* and admissibility issue are

dealt with, at least by the Justices other than Justice Gummow, in an incomplete and piecemeal fashion.

177. Justice Heydon said that to the extent that the challenge had not been abandoned he agreed with the reasons given by Justice Hayne for rejecting it. Justice Hayne rejected it because he considered there were no grounds for barring a proof by a purchaser from the subscribing shareholder. The rationale which had been relied on for barring a proof by the original shareholder could have no relevance in this case. But he accepted that the Maintenance of Capital Rule could be relevant to and a justification for refusing to allow such an original subscriber to prove. He said this (at [190]) (underlining added):

> *"The conclusion reached in Webb Distributors concerned, and concerned only, the rights of a member who had subscribed for shares, as distinct from having acquired shares by contract from a person other than the company itself. Maintenance of capital may be relevant to a shareholder's entitlement to recover from the company amounts that the shareholder subscribed as capital, but it has no direct relevance to the recovery from the company of damages for loss occasioned by the making of a contract to acquire existing shares in the company from a third party. It has no direct relevance to that second kind of case because the shareholder does not seek the return of what was subscribed as capital when the shares were allotted. Whether, in the first kind of case, it is right to describe the claim as one which seeks the return of what was subscribed is a question that need not be answered here. Even if it were right, it would provide no reason for concluding that a shareholder like Mr Margaretic, who was not a subscriber, has no claim against the company under the consumer and investor protection provisions mentioned at the start of these reasons. Nor would it provide a reason for concluding that such a shareholder had no claim for deceit. Neither Webb Distributors nor Houldsworth established any common law 'principle' that no shareholder, no matter how the shares were acquired, can have a claim of the kind now in issue against a company whose assets were to be administered as on a liquidation. The reasoning in those cases, because it was founded in important respects upon considerations of preservation of capital, can have no direct application when the plaintiff shareholder did not subscribe capital. But whether or not that is so, the asserted common law 'principle' could not deny the operation of the relevant consumer protection and investor protection provisions. Finally, the conclusion reached in Webb Distributors, like the conclusion reached in Houldsworth, turned, in important respects, upon whether the shareholder could rescind the contract with the company for subscription for shares. None of these considerations is relevant to the present matters where there was no contract for the acquisition of shares made between the shareholder, Mr Margaretic, and the company, Gwalia."*

178. Chief Justice Gleeson did not say that *Houldsworth* was not authority for the no-proof proposition. He simply said (at page 473h) that the case was "*never authority for a*

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principle as wide as that asserted by [ING." ING had argued, as explained at [13], that "*there is a principle of common law* *__emerging from__* *Houldsworth, which precludes a shareholder from proving in a winding up … for damages for misrepresentation inducing* *__any acquisition of shares__* *unless the shareholder has first rescinded the 'membership contract*' *[and rescission was no longer available after the company became insolvent or went into liquidation]*." Thus, the Chief Justice recognised that what was important was the proposition of law emerging from and to be derived from the case law following *Houldsworth* and was saying that this proposition of law never purported to bar a claim by a shareholder who had purchased their shares from the original shareholder.

179. Gleeson CJ seems to have accepted that the Capital Maintenance Rule was or could have been a proper justification for barring a proof by an original shareholder and that this reasoning had influenced the majority's decision to treat section 360(1)(k) as applying to the non-withdrawable shareholders in *Webb*. He noted (at [26]) that the approval given by the majority in *Webb* to the reasoning of Kay J in *Addlestone* suggested that on the issue of the capacity in which sums were due to the claimants the conclusion that the sums were due to them in their capacity as members was reinforced by the idea that they were in substance seeking to recover capital they had subscribed (and also see [the reference to capital maintenance at [31]). However, he was satisfied (at [31]) that Mr Margaretic was not to be treated as seeking to recover paid-up capital.

180. Crennan J agreed with both Gleeson CJ and Hayne J. He also said that he agreed with Justice Gummow's reasons and analysis of the principle to be derived from *Houldsworth*, to which I now turn.

181. Justice Gummow rejected ING's challenge to Mr Margaretic's right to prove based on *Houldsworth* (see [98]). He noted (at [48]) that ING had relied in its supplementary submissions on the rule in *Houldsworth* and its significance for *Webb* in support of that challenge. He said (at [49]) that in Australia the existence of "*any such common law principle should be rejected.*"

182. Justice Gummow's starting point in his analysis is important. He said (at [34]) that the resolution of the issues in the appeal turned "*upon the construction*" of the 2001 Act and that:

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> *"35 The apparently seamless continuity in the reception and development of the common law in Australia is apt to distract attention from the supreme importance of statute law. In this vein, the submissions presented on these appeals proceeded from an implicit premise which is false.*
>
> *36 There are no 'general principles of company law' applicable in a winding up and to which there must be reconciled those provisions of the 2001 Act and its predecessors (beginning with the Companies Act 1862 … which stipulate a particular system of proof of debts and the ranking of debts and the placement of 'shareholder claims' in that system.*
>
> *37. Further in any quest to locate such general principles, the older case law is not always a satisfactory guide. Excessive significance should not be attributed to statements in nineteenth century British cases decided at a time of endeavours to 'flesh out' the developing body of statute law by use of principles derived from a range of sources in the general law.."*

183. Justice Gummow thus considered that in Australia the common law rules developed in England could have no role to play when interpreting and deciding the effect of the more recent and local statutory regime governing the admission of proofs in a winding up. As I have already explained, I do not consider that this approach is the same as or consistent with the approach taken in England to the role of the common law or in my view to the approach which should be taken in this jurisdiction where our company and insolvency law is to be considered as still closely aligned with and derived from the English law.

184. Justice Gummow did go on to consider in some detail the decision in *Houldsworth* and *Addlestone* particularly in light of their treatment in *Webb*. He said (at [53]) that the first proposition on which the decision in *Webb* had rested was that "*the share capital represents a guarantee fund and protection to creditors which should not be returned to shareholders other than on a permissible reduction of capital*." However, he concluded (at [96]) that this (and the other propositions on which *Webb* was said to be based) was "*open to question*" and "*should not be accepted as correct as they relate to the 2001 Act*." So he linked his decision to the construction of this Australian statute. He also noted (at 97]) that *Webb* was based on a different statute (section 360(1)(k)) with different language "*whereas Hayne J indicates claims of the kind now brought by Mr Margaretic would not have been admissible to proof*." As I have already noted, section 360(1)(k) is in the same terms as section 49(g) while section 563A of the 2001 Act is drafted differently.

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185. Justice Gummow considered (see [67]) that *Houldsworth* had not been determined "*by reference to the law respecting admission or ranking of claims in a winding up conducted in accordance with section 38 of the 1862 Act*" and had decided that the claim was invalid for other reasons. It appears from his analysis of the issues raised and the reasoning in the judgments in *Houldsworth* that he considered that *Houldsworth* was not itself a maintenance of capital case. Rather the case dealt with (a) the application to the case of a defrauded shareholder of the rule that a purchaser of goods who bought under a fraudulent misrepresentation was entitled to retain the goods and recover damages - the defrauded shareholder who retained his shares was not entitled to the same relief because such damages were inconsistent with the contract into which he had entered and by which he wished or was required to abide (an approach emphasised by Earl Cairns LC) and (b) the extent to which the law of agency rendered a company liable for the fraud of its directors (on which Lord Selborne and Lord Blackburn particularly relied). He also thought (perhaps speculated is a better description) (see [84]) that there was no justification for a maintenance of capital rule after the 1862 Act had permitted a company to carry on business even after it had exhausted its capital through trading.

186. Justice Gummow did recognise (at [86]) that the case "*must be understood in the milieu of developing doctrine applicable to company law*" and that (at [63]) it represented "*the gradual development of legal thought respecting the nature of corporate personality.*"

187. So in my view at least three of the majority of six Justices cannot be taken to disagree fundamentally with the existence of the no-proof proposition based on the Maintenance of Capital Rule and Justice Gummow's approach is based to a significant extent on his view that the Australian statute law governing the right to prove in a winding up was not to be construed or treated as qualified by reference to common law rules developed in another jurisdiction (England) a long time before the enactment of the Australian statute.

Televest

188. I do not find the approach taken by Justice Ground to be persuasive.

189. The learned judge in his admirably succinct judgment started from a clear view of the merits and was obviously anxious to avoid what he considered would be, on the facts, a

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serious injustice. This was the result of "*the mere chance*" (see page 2) that some investors received preferred shares and others notes (with the consequence of different rankings in a winding up). He noted (at page 3) that "*in an attempt to avoid the consequences of this*" the preferred shareholders had sought to maintain claims based on misrepresentation.

190. Justice Ground rejected, rightly in my view, the argument made by the preferred shareholders that he could ignore *Houldsworth* and *Addlestone* as being only a decision of the House of Lords or because of the history of statutory intervention in other jurisdictions. However, he did consider that the common law rule barring a proof by a shareholder for damages for misrepresentation did not apply on the facts because it only applied in cases where shareholders were in a "*real sense a member of the company and can participate in its decisions*" (see page 3) and in a *"real partnership"* together (see page 4). The holders of the redeemable preference shares had no such rights to participate in decision making (by for example appointing directors) and were not treated as partners and liable to contribute as Mr Houldsworth was. However, for the reasons I have given above, I do not consider that these matters prevent the application of the no-proof proposition or justify a departure from the Maintenance of Capital Rule.

191. Justice Ground also relied on the fact (see page 4) that the preferred shares "*were essentially an investment vehicle*." He noted that they could terminate their liability to contribute capital at any time when the company was solvent by giving notice to redeem. The preferred shareholders had therefore not "*in any meaningful sense become a part of the company" so as to be "essentially suing themselves*." But once again, for the reasons I have given, I do not consider that the application of the no-proof proposition depends on whether a shareholder has become part of the company such that it would be regarded as suing itself were its claim for misrepresentation to be admitted. The no-proof proposition is based on the need to respect the Maintenance of Capital Rule and its application depends on whether the shareholder has contributed capital which is required to be maintained and is subject to that rule. To the extent that it can be said that redeemable preference shares of the kind in issue in *Televest* were not part of the company's capital in this sense and if the damages claim could be treated as a claim for the payment of sums which did not constitute or represent such capital then it would be

possible to justify Ground J's decision. I must now turn to the question of the treatment and status as capital of the redeemable preference shares in issue in this case.

The meaning of capital for the purposes of the Maintenance of Capital Rule and the treatment of redeemable shares under the Companies Act

192. The Capital Maintenance Rule relates to and governs the withdrawal (and the return to shareholders) of a company's legal capital. This is, in general terms, the fund of contributions made by shareholders when subscribing for (and in consideration for the issue of) their shares. As I have noted, the rules providing for the maintenance of capital were first formulated in the nineteenth century decisions I have referred to but are now largely governed by statute. In this jurisdiction, the main statutory provisions regulating the share capital of a company limited by shares are set out in sections 8, 13-19, 33-35, 37, 37A and 37B of the Companies Act (together with section 49 concerning the liability of members). These provisions permit, subject to the satisfaction of certain conditions, shares to be issued without a nominal or par value and at a discount.

193. As Lord Sumption and Lord Briggs said in their majority judgment in *DD Growth* at [4] "*Cayman law (like the law of the UK) has always contained restrictions upon the ability of a company to reduce its capital, primarily for the protection of its creditors. Although originally to be found in judge-made law, they are now almost completely statutory*." However, as both Lord Sumption and Lord Briggs, and Lord Hodge in his dissenting judgment, acknowledged, there are material differences between the UK and Cayman regimes as a result of legislative amendments in this jurisdiction since 1987.

194. The nature and extent of these differences were discussed by Lord Sumption and Lord Briggs at [47]-[50] of their judgment as follows (underlining added):

> *"47. Turning to the wider legislative history, counsel for both parties travelled at length through the history of the common law and statutory provision for the maintenance of capital, beginning with Trevor v Whitworth (1887) 12 App. Cas. 409 and continuing through the UK Companies Acts from 1929 onwards into the Cayman Islands legislation which, in its original form in 1963, mirrored that to be found in the UK Companies Act 1948 . Thereafter the two legislative schemes diverged.*
>
> *48. The argument for RMF was that, in the context of a progressive liberalisation of the regime for the maintenance of capital, share premium account had,*

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<u>from 1948 in the UK and from 1963 in the Cayman Islands, been available for the payment of a premium on redemption of shares without any requirement for commercial solvency. For completeness, it was pointed out that this has clearly been the position from 2011, when share premium account was, by further amendment of s.37(5)(a), clearly excluded from the definition of capital payments.</u> Why, it was asked rhetorically, should there have been a blip in that process of liberalisation which applied a solvency test to the use of share premium account for this purpose, which had previously been absent?

49. *The answer in the Board's judgment is that, prior to 1987, Cayman law permitted only the issue and redemption of preference shares, rather than equity shares, following in that respect the precedent set by the Companies Act 1948. In sharp contrast with shares of the type in issue in these proceedings, where the premium may exceed the nominal amount by several orders of magnitude, the premium likely to be payable upon the redemption of preference shares would typically be modest, limited to some capitalisation of coupon, unpaid on early redemption. The propensity for permitting the premium payable on redemption of equity shares to undermine capital maintenance, by comparison with preference shares, was perceptively analysed by <u>Professor Gower</u> in 1980 in his consultative report "The Purchase by a company of its Own Shares" (Cmnd 7944). At [22], after pointing out that s.58 of the Companies Act 1948 permitted a premium payable on redemption to be provided for out of share premium account, he continued:*

> *"This anomaly may not matter much in the case of preference shares in the strict sense, where the premiums are likely to be small. <u>But in relation to redeemable equity shares the premiums might well be many times the nominal value, resulting in a substantial reduction of capital on redemption. It is therefore suggested that sections 56 and 58 should be amended so as to prevent redeemable shares from being redeemed otherwise than out of profits or an issue of new capital without any use of share premium account which would be left intact</u>."*

50. *<u>In due course, the UK Parliament followed that advice and prohibited the use of share premium account for the payment of premium on redemption of shares, when extending the ability of a company to issue and redeem shares from preference shares to equity shares. This was done in the Companies Act 1981. By contrast, in 1987 the Cayman Islands adopted a more nuanced approach. The ability to issue and redeem shares was extended from preference shares to equity shares, and share premium account was permitted to be used for funding the premium payable on redemption. It is not surprising in that context that the Cayman Islands legislature took the more modest step of imposing a solvency test from the use of share premium account for that purpose rather than, as in the UK, prohibiting it altogether. It may well be that this was done specifically to permit or encourage the use of shares and share premium as an investment vehicle in the way commonly used by open-ended investment companies as illustrated by the facts of this appeal. There was no time before 2011 at which, in the Cayman Islands,</u>*

redeemable equity shares could be issued, or redeemed, when there was also an uncontrolled right to fund premium payable on redemption out of share premium account. If the solvency test was imposed in 1987, as the Board considers that it was, it cannot in the light of the legislative history sensibly be described as some unaccountable blip in an otherwise seamless liberalisation of the capital maintenance regime."

195. This discussion acknowledges the process of liberalisation of aspects of the capital maintenance regime in this jurisdiction, the significance of the enactment of legislation to permit the issue of redeemable preference shares in 1987 and the importance of Parliament's further and clear decision in 2011 to confirm by the amendment to section 37(5)(a) that the payment of premium due on the redemption of shares could be made out of the share premium account without the need to satisfy the statutory solvency test (on the basis that the sums credited to that account are not treated as a payment out of capital). I also acknowledge from my own experience of dealing with relevant cases (even though no evidence has been adduced from investors or market participants as to the attitudes and expectations of those who invest in redeemable shares in Cayman funds and vehicles) that since holders of redeemable shares rarely if ever have decision making powers (in relation to the appointment of directors or with respect to management) their ability to redeem rapidly and withdraw their funds is of real practical importance.

196. Lord Hodge agreed. As he said at [67] of his judgment: "*The relevant provisions of the 2007 Companies Law are the consolidation of provisions introduced in 1963, 1987 and 1989. The legislative history of the current provisions, which have been set out at [33] above, differs markedly from the way in which companies legislation in the UK has regulated the share premium account. The policies behind the legislation in the UK do not, in my view, provide a reliable guide as to the meaning of the 2007 Companies Law*." Lord Hodge differed from the majority because in his view, on the proper construction of the Cayman Islands legislation, the payment of premium due on the redemption of shares out of the share premium account was permissible without the need to satisfy the solvency test even before the 2011 amendment. He also noted at [69] that *".. in 1987 company law in the Cayman Islands was altered radically when companies were empowered to issue redeemable equity shares*."

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197. So there is a clear difference in the capital maintenance rules in this jurisdiction and England as they relate to the use of sums credited to the share premium account to pay the premium due on the redemption of redeemable shares. The position under English law is different. As the current edition of Gower (11th ed., 2021 at 16-006) puts it, (the strong language used revealing the significance of the different approach taken in this jurisdiction):

> *"It is clear that the amount received by the company by way of the nominal value of the shares issued constitutes part of its legal capital. The amount (often much more significant) received by way of premium is today treated in much the same way. Prior to 1948, when companies issued shares at a premium, the value of the premium was treated differently from the par value. Legal capital was regarded as determined by the nominal or par value of the shares; if they had been issued at price above par the excess was not "capital" and indeed constituted part of the distributable surplus which the company ... could return to the shareholders by way of dividend. This was of course a ridiculous rule except on the basis that it might be an indirect way of subverting the capital based distribution rules."*

198. In this case, as the JOLs pointed out, only a minute part of the subscription price paid by Investors represented the nominal value of the shares. The overwhelming majority of each subscription price was premium which was credited to the share premium account. The JOLs argue that in light of the legislative regime, and in particular since under the Companies Act payments out of the share premium account to pay the redemption price are not treated as payments out of capital, admitting to proof in the liquidation the damages claims of the Misrepresentation Claimants cannot be treated as or give rise to a breach of the Capital Maintenance Rule as that rule applies in this jurisdiction. The no-proof proposition (and the Houldsworth Rule) cannot operate to bar the admission of the Misrepresentation Claims.

199. The JOLs say, as I have noted, that the Misrepresentation Claims are likely to be for damages representing the difference between the sums subscribed by Investors for their shares and the actual value of those shares at the time of the liquidation. They argue, as I understand their case, that since the amount subscribed was almost entirely in respect of premium it follows that the damages claims represent compensation flowing from the payment of, and in respect of, that premium and should be treated, for capital maintenance purposes, in the same way as the payment of premium on a redemption and therefore as not involving a payment out of capital. Putting the point more broadly, they

say that since the sums owing on redemption can be paid out of the share premium account even if the company cannot satisfy the statutory cash flow insolvency test, there can be no objection on capital maintenance grounds to admitting the Misrepresentation Claims in the winding up.

200. Eiffel agrees that the Misrepresentation Claimants' claims for damages for misrepresentation are intended to put them in the position that they would have been in had they not invested and that this includes compensatory damages for having contributed such amount as represents the base capital invested. However, Eiffel submits that a claim for damages for is not the same as a redemption. Payment of such a claim would amount to a distribution because it is essentially a return of capital and is therefore subject to the conditions and proviso in section 34(2). A redemption or a claim for the redemption price is calculated on a different basis (NAV), which bears only a limited relationship to the sums initially invested. There is another difference. If a claim for damages was admitted, the Misrepresentation Claimants' shares are not cancelled and DLIFF would not get the shares back.

201. The basis and calculation of a claim for damages for deceit was not dealt with in depth in the parties' submissions but I accept that, as a general matter, it is right to say that they are calculated on the basis that the claimant is to be put in the position they would have been in if the tort had not been committed. This means getting back what they paid less the value of what they received. As was held by the House of Lords in *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1997] AC 254 in the context of a shareholder claim based on a false representation, the general rule means that damages will be assessed on the date on which the securities were purchased (the transaction date). Accordingly, the amount will be calculated as the difference between the price paid for the shares and their actual/true value as at the transaction date. But this is not an absolute rule and claimants may seek to depart from the general rule, for example by seeking to recover the difference between the price paid for the shares and the amount realised on disposal of the shares (which is often one of the methods by which damages are calculated and will be an attractive option where there has been a later fall in value of the shares). I assume that this is the reason why the JOLs say that in this case it can be expected that the Misrepresentation Claimants will seek to calculate their loss

by reference to the difference between the subscription price and the nil value of their shares at the date of the winding up.

202. So I accept that it can be said that the damages claim will compensate the holders of redeemable preference shares for (and to that extent can be said to represent) the value of what they paid on subscription and that almost all of that was premium. The shareholder is getting back from the company the financial equivalent of what he/she paid for the shares. The shareholder is entitled to get back what it paid but must give credit for the value of what it received. The problem for the JOLs is that the Companies Act does not say that any payment representing premium (or the return of premium) can be made without satisfying the statutory solvency test and, furthermore, it regulates the ranking and treatment of a claim in the winding up for the unpaid redemption price.

203. The qualification to the capital maintenance rule as it relates to the payment of premium on the redemption of shares is narrowly focused and precisely defined. It is a permission to pay (a) upon redemption (b) out of the share premium account (c) prior to the commencement of the liquidation in circumstances where (d) distributions must satisfy the statutory solvency test and (e) the statute provides that in the winding up sums owing in respect of the unpaid redemption price, if provable at all, are subordinated to the payment of non-member creditors.

204. But the damages claim is in law not a claim for payment of the redemption price. The cause of action is different. The shareholder has and retains the shares and is not seeking to exercise the right to redeem. Instead, where there is no rescission, the shareholder claims (*inter alia*) for the difference between the value of the shares he/she holds and the subscription price.

205. Even if the damages claim could, adopting the substance over form approach which is generally used when applying the Capital Maintenance Rule (see *Progress Property* and *Aveling Barford*), be treated as a claim for the payment (return of) the premium paid on subscription, it is not a payment out of capital for the purpose of section 37(5)(a) and (b), where there is no redemption. The substance over form approach strongly suggests that the correct characterisation of the misrepresentation claims is as a return of capital

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(mainly premium) otherwise than on and by way of redemption (and therefore a distribution).

206. In any event, and critically, section 37(7) and section 49(g) make it clear that even where a holder of redeemable preference shares (who has exercised his/her right to redeem or was entitled to do so before the winding up) is entitled to prove in the winding up for the unpaid redemption price, his/her claims rank after those of non-member creditors and therefore, to that extent, remain subject to the Capital Maintenance Rule. There is no exemption from the Capital Maintenance Rule for unpaid redemption creditors and so it cannot be said that there is such an exemption for shareholders with misrepresentation claims. The statutory permission to pay sums due on redemption out of the share premium account without the need to satisfy the solvency test is substituted following the commencement of the winding up by the rules as to proof and ranking set out in sections 37(7) and 49(g).

207. Accordingly, I reject the JOLs' submission that there can be no objection to admitting the Misrepresentation Claims on capital maintenance grounds because of the provisions in the Companies Act which permit sums due on redemption to be paid out of the share premium account without the need to satisfy the statutory solvency test.

Can and should this Court refuse to follow the Houldsworth Principle?

208. I note Justice Doyle's detailed, wide ranging and scholarly review of the authorities from multiple jurisdictions and the related literature dealing with the precedential value and weight to be given to decisions of the House of Lords, Privy Council and foreign courts. He set out the principles which he derived from these authorities at [70] of Justice Doyle's Judgment and I would gratefully adopt and follow his statement of the position (but emphasise that most of the points identified are factors to be taken into account in a broad based assessment of whether in any particular case English law is to be treated as having been received into and a part of Cayman Islands law).

209. I generally accept Eiffel's submissions on this issue (with some exceptions which I mention below). I have carefully considered the various authorities relied on by the JOLs (and the authorities and principles identified by Justice Doyle). I have also carefully

considered the submissions made by the JOLs but I am unable to accept them. Therefore, and with some serious hesitation and reluctance because I am differing from Justice Doyle's conclusion, I consider that the English cases demonstrate that there is a common law rule which applies and should be applied in this jurisdiction (based on the rules of capital maintenance that underlie English and Cayman corporate law) that affects and qualifies the right of shareholders claiming damages for misrepresentation to prove in a winding up. The decisions leading up to *Soden* which I have discussed are obviously not binding on me, but I do regard the reasoning and decision in *Soden* as of considerable persuasive authority and weight.

210. It seems to me that, for the reasons I have given, the no-proof proposition (giving effect to and being part of the Maintenance of Capital Rule) was good law and a common law rule in England before the 1989 Companies Act and that in the absence of a similar legislative intervention here, it has been and remains a common law rule in this jurisdiction. Our company law (in particular the law governing the maintenance of capital and proof in a winding up) is, as a general matter, derived from and based on English law and while there are significant differences of approach in respect of redeemable shares and the use of funds credited to the share premium account to pay premiums on redemption, the differences do not, in my view, justify the conclusion that the no-proof proposition is inconsistent with or has been abrogated or its rationale undermined by the relevant provisions of the Companies Act. The no-proof proposition is embedded in and an important part of the common law rules regulating the maintenance of capital (in both England and this jurisdiction) and cannot be treated as a distinct rule that can be separated and discarded. The no-proof proposition, as I have explained, is not just based on *Houldsworth* but also on the various cases after it that worked out and defined the scope and effect of the Maintenance of Capital Rule. To say that *Houldsworth* was decided a long time ago when company law was in its infancy seems to me to be beside the point. The case law as a whole up to *Soden* needs to be considered and taken into account. Furthermore, as I have also explained, in my view it is well established here and in England that common law rules can operate alongside the statutory code governing company liquidations.

211. I accept, as I have said, that company law in this jurisdiction has diverged in material respects from that in England and that the importance of redeemable shares for the funds

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and financial services industry has driven many of the changes. But the application of the no-proof proposition does not undermine or threaten the rights or position of holders of redeemable shares. At least, no evidence was adduced to show that it did. Even redemption creditors who have given notice of redemption and not been paid are subordinated to the rights of non-member creditors. I can see and take it that the JOLs' main objection was to the application of the no-proof proposition as an absolute bar to proof. But I have concluded that the no-proof proposition as properly understood (or, if necessary, as should be applied in this jurisdiction) only operates as a qualification to the right to prove.

212. I also accept that we do not look only to the case law in England when considering what the common law rules applicable to companies are and should be and that decisions of the High Court of Australia are also of considerable weight. But, as I have explained, I do not regard the reasoning of the majority in *Sons of Gwalia* as demonstrating that the reasoning in the English cases in general and in *Soden* in particular is obviously wrong or otherwise not persuasive or an affront to common sense (to use the language of Justice Doyle's factors in [70(g)] and [70(i)] respectively). It seems to me that there were strong local factors which influenced the views and reasoning of the majority and that there was no clear, uniform and persuasive rejection of the application of capital maintenance rules in a different statutory context as applies in this jurisdiction (we have no statute which evidences a strong public policy to allow investors who have been defrauded to rank equally with all creditors). For the reasons I have given, I also do not find that the decision of Justice Ground in *Televest* provides a basis for rejecting the no-proof proposition as part of Cayman law (nor did I find the reasoning Justice Chua Lee Ming in *Song Jianbo* persuasive).

213. I do not accept that it follows that because the English Parliament has (and other legislatures have) chosen to enact legislation to give shareholders with misrepresentation claims, or to clarify the law to confirm that such shareholders have, a right to prove this Court should treat Cayman Islands law as similarly amended or that the common law before amendment should *ipso facto* be treated as having been wrong or flawed. The foreign legislation represents a decision of the local government to change the law. It is then a matter for our Parliament to decide whether to follow suit and enact amending legislation. I agree with Eiffel that it is significant that the Cayman Islands Parliament

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has not done so. The decision of another government (particularly the UK government) to change the law is a factor to be taken into account when considering whether to modify a common law rule in this jurisdiction but for my part there would need to be a clear and compelling reason in order to justify this Court making the amendment to the law rather than leaving it to the Cayman Parliament to follow the foreign governments. I certainly consider that it would be wrong for this Court to modify or abrogate a common law rule on the basis of the needs and wishes of investors in the funds sector without at least clear and comprehensive evidence on the position being adduced (see the reasons for caution given by Lord Neuberger in *International Energy Group*).

214. I agree with the JOLs that the *dicta* of Smellie CJ referring to *Houldsworth* in *SPhinX* did not amount to a binding endorsement and approval of the Houldsworth Principle but it does in my view reflect a common understanding and assumption within the Cayman profession that the right of shareholders making misrepresentation claims to prove was qualified.

215. I also agree with the JOLs that Eiffel's floodgates argument was exaggerated and unpersuasive.

216. As will be clear, I do not accept the four arguments made by the JOLs and summarised at [114] above as to why there are good grounds for adopting a different approach in this jurisdiction from that established by *Houldsworth* and the subsequent case law. I accept that Eiffel seeks to establish as a common law rule in this jurisdiction a proposition that was not part of, or clearly part of, the *ratio* of *Houldsworth* but that does not fundamentally affect the analysis. *Houldsworth* and the other cases rely on establishing the common law rule and in my view that rule applied in England and still applies in this jurisdiction.

217. It seems to me that when taking into account all of the factors that have been relied on by the JOLs, and having regard to the factors listed by Mr Justice Doyle at [70] of Justice Doyle's Judgment, there is no sufficient basis justifying a refusal by this Court to treat the no-proof proposition as good law or to refuse to apply it in this jurisdiction, at least as I have formulated it. To the extent that it could be said that I am wrong as to the proper formulation of the no-proof proposition as a matter of English law and that in English

law it imposes an absolute and permanent bar on the proof of misrepresentation claims, then I would hold that the no-proof proposition should only be treated as incorporated into and as part of Cayman Islands law in the formulation I have given it.

The Priority Point - the statutory provisions

218. I have already referred to and quoted from section 49 of the Companies Act but it is as well to set out again at this point the core statutory language:

> *"In the event of a company being wound up every present and past member of such company shall be liable to contribute to the assets of the company to an amount sufficient for payment of the debts and liabilities of the company, and the costs, charges and expenses of the winding up and for the payment of such sums as may be required for the adjustment of the rights of the contributories amongst themselves:*
>
> *Provided that —*
>
> …….
>
> *(g). no sum due to any member of a company in that person's character of a member by way of dividends, profits or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between that person and any other creditor not being a member of the company; but any such sum may be taken into account for the purposes of the final adjustment of the rights of the contributions amongst themselves."*

219. Section 37(7) of the Companies Act states as follows:

> *(a) Where a company is being wound up and, at the commencement of the winding up, any of its shares which are or are liable to be redeemed have not been redeemed or which the company has agreed to purchase have not been purchased, the terms of redemption or purchase may be enforced against the company, and when shares are redeemed or purchased under this subsection they shall be treated as cancelled.*
>
> *Provided that this paragraph shall not apply if —*
>
> *(i) the terms of redemption or purchase provided for the redemption or purchase to take place at a date later than the date of the commencement of the winding up; or*
>
> *(ii) during the period beginning with the date on which the redemption or purchase was to have taken place and ending with the commencement*

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of the winding up the company could not, at any time, have lawfully made a distribution equal in value to the price at which the shares were to have been redeemed or purchased.

(b) There shall be paid in priority to any amount which the company is liable by virtue of paragraph (a) to pay in respect of any shares — (i) all other debts and liabilities of the company (other than any due to members in their character as such); and (ii) if other shares carry rights whether as to capital or as to income which are preferred to the rights as to capital attaching to the first mentioned shares, any amount due in satisfaction of those preferred rights,

but subject to that, any such amount shall be paid in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members."

The Priority Point - Eiffel's submissions

Eiffel's case in outline

220. Eiffel's case in summary is that:

(a). the Misrepresentation Claims arise from the statutory contract between the relevant member and the company and are therefore made by that member in its character as a member. As such, Misrepresentation Claims fall within section 49(g) and are subordinated to the redemption creditors' claims.

(b). the Late Redeemers' claims (and the claims of all shareholders who have redeemed but not been paid) should be treated on the same basis as claims made by shareholders who have a right to enforce their redemption against the company under section 37(7)(a) of the Companies Act. Section 37(7)(a) claims are, by virtue of section 37(7)(b), to be paid in priority to any shareholder claims arising under section 49(g).

(c). the resulting waterfall of priorities (after liquidation expenses and preferential creditors) was therefore: first, all ordinary unsecured creditors (section 37(7)(b)(i)); second, the Late Redeemers' claims (section 37(7)(b)(i) and section 49(g)); third, Misrepresentation Claims (section 37(7)(b)(i)) and fourth the return of equity to shareholders (section 140(1)).

The ranking of the Misrepresentation Claims

221. Eiffel submitted that the question of whether Misrepresentation Claims fall within section 49(g) had not been considered by this Court but was the subject of highly persuasive English and Australian authority, which had decided that such claims were subject to equivalent statutory provisions.

222. Eiffel submitted that in *Addleston*e, the facts of which are summarised above, Kay J regarded it as "*unquestionable*" that the shareholders were making their claims in the character of members (for the purposes of section 38(7) of the Companies Act 1862) and the only question was whether such sums were due "*by way of dividends, profits or otherwise*." He held that they were analogous to a dividend and so were caught by the words "*or otherwise.*" Kay J had considered that the shareholders were from a practical perspective admitting their liability to pay the sum due to the unsecured creditors but seeking to get it back "*out of the pockets of those very creditors themselves*." Eiffel says that the English Court of Appeal (Cotton, Lindley and Lopes LJJ) upheld Kay J in reasoning and result. Lopes LJ approved Kay J's construction of section 38(7) and said (at page 206) that there was no substantial distinction between a claim for breach of contract (as in *Addlestone*) and a claim for misrepresentation (as in *Houldsworth*). Cotton LJ had said (at page 205) that "*I think it would have been very difficult to come to the conclusion that [the claimant shareholders] could compete with outside creditors*."

223. Eiffel also relied on the decision of the High Court of Australia in *Webb* which considered, as noted above, section 360(1)(k) of the Victorian Companies Code. Eiffel relied on the passage in the judgment of Mason CJ (at page 408) quoted above.

224. In addition, Eiffel argued that support for their position was to be found in the judgments of the Court of Appeal and the House of Lords in *Soden*. In the Court of Appeal (Peter Gibson LJ, giving the judgment of the court) held that *Webb* was of "*high persuasive authority for the proposition that damages in tort for misrepresentation by a company as to the nature of its shares, which induces a contract to subscribe for shares in the company, come within section 74(2)(f)*." In the House of Lords, Lord Browne-Wilkinson had drawn a distinction between a claim for misrepresentation made by an original

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subscriber and by a person who had purchased his shares from an original subscriber (or from another shareholder). *Soden* involved the latter type of claimant and Lord Browne-Wilkinson had concluded that a claim by a purchaser of shares that had already been issued was not covered by section 74(2)(f). Eiffel argued that Lord Browne-Wilkinson had justified this distinction in part on the same basis as had been adopted in *Addlestone* and *Webb*, namely the protection of creditors from indirect reductions of capital. Eiffel submitted that this distinction was part of the *ratio* since the analysis of the nature of the two different types of claim and claimant was essential to Lord Browne-Wilkinson's reasoning (and not mere *obiter dicta*). In particular, Lord Browne-Wilkinson had said as follows (page 322-327) (underlining added):

> *"Mr. Potts, for the administrators of Atlantic, submitted that the basic principle applicable was that "members come last," i.e. the members of a company can take nothing until the outside creditors have been paid in full. He further submitted that in the present case there would be a manifest absurdity if B. & C., as shareholder in its wholly owned subsidiary Atlantic, could circumvent that rule by claiming as damages sums quantified by reference to the worth of the Atlantic shares payable in respect of a misrepresentation leading to the acquisition of such shares. This would be to enable B. & C. to convert its position from that of a holder of worthless shares in its wholly owned subsidiary into that of a creditor ranking pari passu with ordinary creditors of that subsidiary.*
>
> *He submitted that a dealing or contract is not independent of the corporate nexus of membership or of the character of membership where such dealing or contract itself brings about the status of membership whether by way of subscription for shares or transfer of shares. In particular, he submits, a claim is maintained in the character of a member where the claimant seeks to recover from the company the price which he has paid for his shares on the basis that such shares are not worth what they were warranted or represented by the company to be worth. The claimant who is induced to acquire his shares by subscription falls within the class of those who are not allowed to compete with general creditors: see In re Addlestone Linoleum Co. (1887) 37 Ch.D. 191 and Webb Distributors (Aust.) Pty. Ltd. v. State of Victoria (1993) 11 A.C.S.R. 731. There is no reason, he submitted, why a claimant who is induced to acquire his shares by purchase (as opposed to allotment) should be in a different position. In short, he submits that a sum is due to a person in his character as a member of a company where it is due to him under the bundle of rights which constitute his shares in the company or by reason of a warranty or misrepresentation on the part of the company going to the characteristics or value of the shares which induces him to acquire those shares.*
>
> *I cannot accept these submissions. Section 74(2)(f) requires a distinction to be drawn between, on the one hand, sums due to a member in his character of a member by way of dividends, profits or otherwise and, on the other hand, sums due to a member otherwise than in his character as a member. In the absence of any other indication to the contrary, sums due in the character of a member must be*

sums falling due under and by virtue of the statutory contract between the members and the company and the members inter se constituted by section 14(1) of the Companies Act 1985…….

A contract to similar effect was prescribed by section 16 of the Act of 1862 and all Acts since then. To the bundle of rights and liabilities created by the memorandum and articles of the company must be added those rights and obligations of members conferred and imposed on members by the Companies Acts….

That this is the correct interpretation is supported by the words in section 74(2)(f) "by way of dividends, profits or otherwise." There was some discussion in the judgment of the Court of Appeal whether these words disclose a genus requiring a sum "otherwise" due to be given a narrow construction under the ejusdem generis rule and as to what, if any, genus was disclosed by the words "by way of dividends, profits." In my view that is not the right approach to the section. The words "by way of dividends, profits or otherwise" are illustrations of what constitute sums due to a member in his character as such. They neither widen nor restrict the meaning of that phrase. But the reference to dividends and profits as examples of sums due in the character of a member entirely accords with the view I have reached as to the meaning of the section since they indicate rights founded on the statutory contract and not otherwise.

Moreover, the construction of the section which I favour accords with principle. The principle is not "members come last:" a member having a cause of action independent of the statutory contract is in no worse a position than any other creditor. The relevant principle is that the rights of members as members come last, i.e. rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights of creditors based on other legal causes of action. ***The rationale of the section is to ensure that the rights of members as such do not compete with the rights of the general body of creditors****. If this is the correct dividing line between sums due in the character of a member and those not so due, there is no room for including in the former class cases where membership, though an essential qualification for acquiring the claim, is not the foundation of the cause of action.*

Mr. Potts placed great reliance on the decisions in the Addlestone and Webb cases, in both of which it was held that a sum due in respect of damages payable for breach of contract or misrepresentation made by the company on the occasion of the issue (as opposed to the purchase) of its shares were held to be excluded by the section. …..

[Kay J in Addlestone] also decided that the claim was excluded by the Houldsworth principle.

In the Court of Appeal, the point under section 38(7) received little attention. Cotton L.J. decided that the shareholders could not prove because the issue of shares at a discount (if it had occurred) was unlawful and that in any event the claim failed under the Houldsworth principle. As to the section 38(7) point he said, obiter, 37 Ch.D. 191 , 205: "I think it would have been very difficult to come to the conclusion that they could compete with the outside creditors." Lindley L.J.

decided the case solely on the Houldsworth principle. Lopes L.J. said that he agreed with the construction put by Kay J. on section 38(7).

If there had been a cause of action in the Addlestone case, it must, as it seems to me, have been based upon the statutory contract between the member and the company. "Dividends" and "profits" represent what might be called positive claims of membership; the fruits which have accrued to the member by virtue of his membership. But the principle must apply equally to negative claims; claims based upon having paid money to the company under the statutory contract which the member says that he is entitled to have refunded by way of compensation for misrepresentation or breach of contract. These, too, are claims necessarily made in his character as a member*. But, in any event, the reasons given by Kay J. for treating the case as falling within section 38(7) are directed exclusively to matters relevant to a claim involving the issue of shares by the company but irrelevant to a claim relating to the purchase of fully paid shares from a third party. Under the statutory contract (including the obligation in the winding up to pay all sums not previously paid on the shares) the claimants were bound to pay the unpaid £2 10s.. in respect of each share. If such a payment were not made the capital of the company would not be maintained and the general body of creditors would be thereby prejudiced. If, in such a case, the member could recover by way of damages for breach of the contract to issue the shares at a discount the same amount as he was bound to contribute on the winding up that would indirectly produce an unauthorised reduction in the capital of the company. Such a failure to maintain the capital of the company would be in conflict with what Lord Macnaghten (in the Ooregum case [1892] A.C. 125 , 145) said was the dominant and cardinal principle of the Companies Acts, i.e. "that the investor shall purchase immunity from liability beyond a certain limit, on the terms that there shall be and remain a liability up to that limit."*

There is nothing in the Addlestone case to justify the application of that decision to cases where the claim against the company is founded on a misrepresentation made by the company on the purchase of existing shares from a third party. To allow proof for such a claim in competition with the general body of creditors does not either directly or indirectly produce a reduction of capital. The general body of creditors are in exactly the same position as they would have been in had the claim been wholly unrelated to shares in the company.

The decision of the High Court of Australia in the Webb case, 11 A.C.S.R. 731 stands on exactly the same footing. .... The High Court held that the claim was excluded by the Houldsworth principle and held that the proposition deducible from that case was that a shareholder may not directly or indirectly receive back any part of his or her contribution to the capital save with the approval of the court. The High Court further relied on the Addlestone decision and section 360(1) but carefully delimited its application to cases of contracts to subscribe for shares. They held, 11 A.C.S.R. 731, 741 that the claim in that case "falls within the area which section 360(1)(k) seeks to regulate: the protection of creditors by maintaining the capital of the company." It is therefore quite clear that both the decision and the reasoning of the High Court were dependent upon the same factors as those in the Addlestone case, i.e. the protection of creditors from indirect reductions of capital. Those are factors relevant to cases of subscription for shares

> *issued by the company but wholly irrelevant to purchases from third parties of already issued shares."*

225. Eiffel noted that Lord Browne-Wilkinson had gone on to discuss section 111A of the UK Companies Act but submitted that he was not doubting that *Houldsworth* remained good law. He clearly, Eiffel argued, considered that *Houldsworth* had been good law before the enactment of that section but did not wish or need to consider the extent to which the principle in or represented by *Houldsworth* had been amended and the extent to which it remained good law in the UK after the enactment of section 111A. Lord Browne-Wilkinson had said this (at page 326-327):

> *"I express no view as to the present law of the United Kingdom where the sum due is in respect of a misrepresentation or breach of contract relating to the issue of shares. Section 111A of the Act of 1985 provides:….*
>
> *It is plain that this section operates so as, at least in part, to override the Houldsworth principle. But to what extent and with what consequential results is not yet clear. All that is necessary for the decision of the present case is to demonstrate, as I have sought to do, that the decisions in Addlestone, 37 Ch.D. 191 and Webb, 11 A.C.S.R. 731 do not apply to claims other than those relating to the issue of shares by the company."*

226. Eiffel submitted that the decision in *Sons of Gwalia* is distinguishable and also that it should not be followed by this Court.

227. Eiffel noted that *Sons of Gwalia* was an open market purchase case and not a subscription case (like *Soden* but unlike *Webb* and this case). The cause of action was a statutory claim for damages for deceptive and misleading conduct, based on section 52 of the Trade Practices Act 1974 and section 12DA of the Australian Securities and Investments Commission Act 2001 and the nub of the decision was that the statutory subordination of claims due to members in their character of members (under section 563A of the Corporations Act 2001) did not apply to claims brought under the statutory tort provisions.

228. Eiffel also said that the result in *Sons of Gwalia* had been seen to have such a damaging impact on the Australian financial community that the Federal legislature was forced to reverse its effect in the Corporations Amendment (Sons of Gwalia) Act 2010. This indicated that the approach adopted in the case was undesirable from a policy perspective.

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In addition, the decision was contrary to *Addlestone* and *Soden*, which although not formally binding on this Court were nonetheless part of the common law of the Cayman Islands.

229. Eiffel submitted that the proper analysis of the ranking of the Misrepresentation Claims could be summarised as follows:

(a). a claim for damages for misrepresentation which induced a contract of subscription for shares was, in economic terms, a claim for restitutionary damages in the amount of the contributed capital. The fact that the cause of action was a common law claim for damages based on a tort was irrelevant. The practical outcome of both from the shareholder's and the company's point of view was a return of capital (both base capital and share premium). That was not so with an open market purchase since the loss claimed was not measured by reference to the subscription price but to the trade price at which the shareholder bought the shares from the seller, which may bear little relationship to the value of the capital originally subscribed for.

(b). a claim for damages for misrepresentation inducing a subscription agreement is founded on the statutory contract because it is via the subscription agreement that the statutory contract comes into being and the member's obligation to contribute capital and other liabilities arise. It was artificial to limit *"sums due to a member in his character as a member*" to those contractually due to and from the company under the articles, as opposed to the subscription agreement and the articles taken together as a single transaction. After all, a subscription agreement was simply an agreement to buy the contract of membership comprised in the articles.

The ranking of claims by the Late Redeemers (redemption creditors)

230. Eiffel argued that the shareholders who had redeemed before the winding up (including the Late Redeemers) (redemption creditors) were only subordinated to non-member creditors. Even if the Misrepresentation Claimants were permitted to prove in the winding up, the redemption creditors ranked ahead of them (and any shareholders holding redeemable shares that came within section 37(7)(a)).

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231. Eiffel relied on the judgments of the Cayman Court of Appeal and the Privy Council in *Re Herald Fund SPC (in official liquidation)* [2016] 2 CILR 330 and [2017] 2 CILR 75 (JCPC) (***Herald***).

232. Eiffel said that *Herald* had decided that unpaid former shareholders whose shares had been redeemed before the commencement of the winding up would have a provable claim as creditors for the redemption price under section 139(1) of the Companies Act, since they had ceased to be members of the company when their shares were redeemed. It had been decided that they were not subject to or caught by section 37(7). That subsection applied only to unredeemed shareholders who had started but not completed the redemption process required by the articles before the commencement of the winding up. Shareholders who had redeemed before the winding up (and therefore who had become creditors) were however subject to section 49(g) since their claims were founded on their contract of membership (the articles). Their claim to the redemption price was therefore postponed, but only postponed, to non-member unsecured creditors. They still ranked ahead of the rights of all other shareholders.

233. Eiffel submitted that the basis on which the Court of Appeal had accorded priority to redemption creditors over ordinary member claims was the power of adjustment as between members contained within section 49(g). Eiffel submitted that Field JA (at [54]) had followed and adopted the analysis of Mitchell JA in *Somers Dublin Ltd v Monarch Pointe Fund Ltd* Eastern Caribbean Supreme Court, (BVI C.A.), Case No. HCVAP/2011/040, 11 March 2013, unreported, per Mitchell JA at [20]-[24].

234. In *Somers,* the Eastern Caribbean Supreme Court in the Court of Appeal considered the purpose and effect of section 197 of the BVI Insolvency Act 2003. That section provides that "*A member, and a past member, of a company may not claim in the liquidation of the company for a sum due to him in his character as a member, whether by way of dividend, profits, redemption proceeds or otherwise, but such sum is to be taken into account for the purposes of the final adjustment of the rights of members and, if appropriate, past members between themselves*." The Eastern Caribbean Supreme Court in the Court of Appeal decided that the purpose of this section was merely to subordinate the former members' claims (along with other claims arising out of membership) as creditors to that of ordinary unsecured (and usually external) creditors. They held that when section 197

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said that a past member "*may not claim in the liquidation*" it must be read as referring to and barring claims as an ordinary unsecured creditor and not as barring claims as a deferred creditor as part of the "*final adjustment of the rights of members and ... past members between themselves*". It had therefore been wrong for the trial judge to have held that the redeemed members in their character as such should rank equally with the continuing members claiming a return on their capital. It was wrong to have held that redeemed members were not deferred creditors and as such entitled to have their claims against the company satisfied in priority to any claim by the continuing members. The redeemed members must be paid before any surplus was ascertained out of which the continuing members would be paid. Eiffel noted that Field JA in *Herald* had said (at [54]) (underlining added) that "*As Mitchell, J.A. said in reference to s.197 of the BVI Insolvency Act in the Somers Dublin Ltd. decision, <u>any adjustment within s.197 must give higher priority to former members who have become creditors as a result of a redemption than to mere continuing members</u>.*"

235. Eiffel submitted that since the Court of Appeal's decision in *Herald* was upheld by the Privy Council, it was binding on this Court and stood as authority for the following propositions:

(a). the claims of redemption creditors (including the Late Redeemers) who had redeemed in accordance with the articles did not fall within section 37(7)(a). They were therefore entitled to prove in accordance with section 139(1) as creditors of DLIFF.

(b). since such redemption creditors were former members of the company and their claims arise out of the statutory contract with the company, their claims engage section 49(g) and are subordinated to the claims of ordinary outside creditors.

(c). although section 37(7)(a) is not engaged in the case of such claims, a redemption creditor's claim ranks ahead of the claims of other shareholders which are subject to section 49(g) by way of adjustment under section 49(g) (following *Somers*) and in the same way that they would do if they had the benefit of the priority given by section 37(7)(b).

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(d). therefore, since the Misrepresentation Claims were made by shareholders in their character as such within section 49(g) the redemption creditors had priority over the Misrepresentation Claimants.

236. Eiffel submitted that the decision of Justice Mangatal in *Re Centaur Litigation SPC* (unreported, 28 November 2017) (***Centaur***) was wrongly decided and should not be followed. That case concerned a group of Cayman Islands investment funds, collectively referred to as the Centaur entities, that were involved in the business of litigation funding. It was subsequently discovered that the funds were a victim of fraud perpetrated on them by their controllers, with some $27m misappropriated. The joint official liquidators of the Centaur entities sought directions and relief in relation to a number of issues. One of the issues related to the relative priority between the claims of former members for the redemption price of their shares and claims by continuing members for other liabilities such as unpaid dividends. The joint official liquidators contended that there was no basis on which to distinguish shareholder creditor claims and redemption creditor claims in the distribution waterfall where there were no claims in the liquidation falling under section 37(7). The joint official liquidators argued that where there were no section 37(7) claims the priority waterfall set out in section 37(7)(b) was not engaged so that the only statutory provision governing priorities was section 49(g), with the result that both types of claim would rank *pari passu*. The liquidation committee submitted that the correct analysis, following *Herald*, was that shareholder debt claims would be subordinated to redemption creditor claims. Mangatal J held that both redemption creditor claims and shareholder debt claims would rank *pari passu*. She considered that section 37(7) did not apply and that therefore the redemption creditors fell back into section 49(g) and ranked *pari passu* with other member claims.

237. Eiffel submitted that Justice Mangatal had in substance ignored the decision in *Herald*. The learned judge had been bound by the *ratio* of *Herald* that redemption creditors, like redeeming members under section 37(7), have priority over member claims. Eiffel argued that Justice Mangatal appeared to have concluded that because section 37(7) did not apply, redemption creditors *ipso facto* enjoyed no priority over member claims. But, Eiffel submitted, that was not right because the Court of Appeal in *Herald* had held that they did, even though not within section 37(7). Justice Mangatal, Eiffel said, had failed to have any regard to the basis on which Field JA had reached his decision, namely the

adoption of the self-same approach by Mitchell JA in *Somers*. That decision covered exactly that point, treating redemption creditors as deferred creditors, ranking behind ordinary unsecured creditors but ahead of member claims. Justice Mangatal had failed to take account of the express language of section 49(g) which required adjustment between member claims, which would include those of redemption creditors. Eiffel argued that the result in *Centaur* was perverse. It meant that members who had not completed their redemption as at the date of the winding up had priority over member claims (by virtue of section 37(7)(b)) but redemption creditors who had completed all necessary steps to redeem and had been redeemed but not paid, would be in a worse position.

238. Eiffel argued that the Court should conclude that although redemption creditors were subordinated by section 49(g) as regards ordinary creditors, they rank ahead of member claims, including the Misrepresentation Claims.

239. In his oral submissions, Mr Millett KC summed up Eiffel's case thus (day 2 transcript page 92):

> *"The underlying legislative intent or fairness, whichever you take, is the conversion from member to creditor. That has to be given full weight and the effect of that is simply to treat redemption creditors, whatever misrepresentation claimants might or might not have, but redemption creditors ... [as] only subordinated to unsecured outside creditors. Section 49(g) has no further subordinating effect and nor does anything else. My Lord, we would simply leave it like this. Although the Privy Council did not examine in detail the question I just showed you about how they would rank amongst themselves, what they were doing is proceeding on the assumption that a redemption creditor must rank at least pari passu with an uncompleted redeemer within section 37 and certainly not junior to him, otherwise the whole analysis would have been completely pointless."*

The Priority Point – the JOLs' submissions

The ranking of the Misrepresentation Claims

240. The JOLs relied on the decision and reasoning of the majority in *Sons of Gwalia* which they submitted was correct and should be applied to the construction of section 49(g) and followed by this Court.

241. As I have explained, the High Court had decided that damages claims brought by a shareholder against the company for misrepresentation were not brought in his capacity as a member of the company in the context and for the purpose of section 563A of the 2001 Act.

242. Justice Hayne said that the starting point was that the relevant obligation had to be linked to the shareholder's membership of the company (at [202]):

> *""Membership" of a company is a statutory concept. That is why the connection between obligation and membership that must be shown, if the obligation is to fall within s 563A, will find its ultimate foundation in the relevant legislation, now the 2001 Act. It is the legislation which defines the obligations owed by and to the members of a company. That definition of obligations will often require resort to the company's constituent documents to flesh out the content of the relevant obligation. It is on that basis that reference is often made to "the statutory contract", but it is the statute (now s 140 of the 2001 Act) which gives those documents their particular legal effect. And in other cases, it will not be necessary to look beyond the four corners of the statute to conclude that the obligation which the member seeks to enforce is an obligation owed to members."*

243. He had then explained what the JOLs described as the critical distinction between a claim to recover monies paid under a contract and a claim to recover monies paid to create a contract (at [205]) (underlining added):

> *"If money is paid to the company under the statutory contract, there may be cases in which it may be said that the obligation which it is then sought to enforce is one whose ultimate foundation is the legislative prescription of the rights of members. Whether that is so would depend entirely upon the facts and circumstances of the particular case and, very probably, would be much affected by the provisions of the company's constituent documents. But if money is paid to the company to create the relationship of member (as will be the case when a person subscribes for shares) the company's obligation to pay damages for fraudulent misrepresentation inducing that subscription, or to pay damages because loss was occasioned by the company's misleading or deceptive conduct, will not, in the absence of specific legislative provision to the contrary, be an obligation whose foundation can be found in the legislative prescription of the rights and duties of members. In this respect, absent specific legislation giving subscribing members particular remedies as members, no distinction is to be drawn between shareholders who complain that a company's deceit or misleading or deceptive conduct induced them to acquire shares in the company according to whether that acquisition was by subscription or transfer."*

244. Having established these principles, Hayne J had rejected the notion that the obligation (whether based upon consumer/investor protection statutes or in the tort of deceit) was an obligation which the 2001 Act created in favour of a company's members. The JOLs submitted that even though the claims of Mr Margaretic were in part based on statutory investor protection provisions under Australian law they were also based in the tort of deceit, and it was clear that Justice Hayne's reasoning did not depend on whether a subscriber's claim relied upon statutory provisions (regarding e.g. investor protection) or the tort of deceit. In either case, by its very nature, the claim was not reliant upon rights or obligations arising under the statutory contract. As Hayne J had said (at [205]-[206]) "*In so far as the claim is put forward in the tort of deceit, it is a claim that stands altogether apart from any obligation created by the 2001 Act and owed by the company to its members. Those claims are not claims 'owed by a company to a person in the person's capacity as a member of the company*'."

245. The JOLs also supported the High Court's conclusion that there was no distinction for these purposes between claims by subscribing investors and claims by transferee investors. They submitted that to the extent that there was any inconsistency between the decisions in *Sons of Gwalia* and *Soden*, the former was to be preferred. It represented a fully reasoned decision of the High Court of Australia which post-dated the *dictum* in *Soden* and which expressly dealt with it as part of a finding of the High Court which formed the *ratio* of the decision. By contrast, Lord Browne-Wilkinson's statement was *obiter*, since as he himself said, all that it was necessary to decide in *Soden* was that the decisions in *Addlestone* and *Webb* did not apply to B&C's claims as a subsequent transferee of the shares.

246. The JOLs argued that the Misrepresentation Claims would not be made by the relevant Investors in their character as members within the meaning of section 49(g). Misrepresentation Claims based on the tort of deceit, whether brought by subscribing Investors or transferee Investors, did not constitute claims made by such investors "*in their character as members*" since such claims were not founded upon obligations owed by DLIFF under the statutory contract of membership (e.g. to pay dividends, to return capital) and the causes of action did not depend on, and were not based on, the statutory contract. Rather, the claims were founded on tortious acts and statutory wrongs committed by DLIFF. Whilst the quantum of the damages claims might in part be

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measured by the subscription amount, they were not necessarily limited to this since the object of the damages is to compensate the claimant for all the loss he/she has suffered which may include a loss of profits.

The ranking of claims by the Late Redeemers (redemption creditors)

247. The JOLs submitted that if the Court found, contrary to their primary case, that the Misrepresentation Claims were subject to and subordinated by section 49(g), then they would rank *pari passu* with the claims of the Late Redeemers (and after the claims of external creditors who were given priority by section 49(g)).

248. The JOLs argued that the Court should reject Eiffel's submission that where the Misrepresentation Claims were subject to section 49(g) the claims of the Late Redeemers should rank ahead of such claim. They relied on the decision of Mangatal J in *Centaur* that *"there remains no statutory or common law basis on which to distinguish Shareholder creditor Claims within the distribution waterfall."*

249. The JOLs said that Eiffel had argued that the Court of Appeal in *Herald* had held that redemption claims should rank as if they were claims under section 37(7)(a), even if they were not to be treated as such. Eiffel had relied on [55] of the judgment of Field JA in the Court of Appeal (although it is helpful to set out [52]-[55] to provide the proper context):

> *"52 In proving their claims under s.139(1), the claimants would be acting in the capacity of creditors. They ceased to be members of Herald once their shares were redeemed under the articles: see Somers Dublin Ltd. v. Monarch Pointe Fund Ltd. (5) which is considered in para. 54 below.*
>
> *53. Pursuant to s.49(g) of the Companies Law, the claims would rank, in my opinion, behind the claims of Herald's ordinary creditors. As recorded above, the respondent submitted to the contrary, relying on the reasoning in Western Union Intl. Ltd. v. Reserve Intl. Liquidity Fund Ltd. (7) where, in reference to s.197 of the BVI Insolvency Act, Bannister, J. held that a claim for redemption proceeds in a liquidation is not a claim founded on the statutory contract between a member and the company but arises after the claimant has ceased to be a member. With respect, I decline to accept this reasoning. Although the claimants ceased to be members of Herald upon redemption of their shares, their claims for redemption proceeds would be founded on the statutory contract between them as members and Herald and*

as such would be claims for sums "due to any member of a company in his character of a member" within s.49(g).

54. *However, the claimants' claims would rank ahead of the entitlement of other Herald shareholders to be paid sums due to them in their capacity of members. As Mitchell, J.A. said in reference to s.197 of the BVI Insolvency Act in the Somers Dublin Ltd. decision, any adjustment within s.197 must give higher priority to former members who have become creditors as a result of a redemption than to mere continuing members.*

55. *In terms of ranking, the outcome of the postulated claims would therefore be the same as the outcome of a successful claim under s.37(7)(a), which puts paid to the appellant's contention that it cannot have been intended that shareholders of shares redeemed under the articles without payment of the redemption proceeds could claim in the company's liquidation otherwise than under s.37(7)(a) because the outcome of such a claim would see the claimants ranking pari passu with the outside creditors."*

250. The JOLs submitted that this remark could not be taken as a determination that, as a matter of law, a redemption claim for unpaid redemption proceeds was to be treated as falling within section 37(7)(a) for priority purposes. It appeared more likely that the point that Field JA was making was simply that redemption claims and section 37(7)(a) do enjoy the same outcome to the extent that both rank above the claims of remaining shareholders. In any event, the comments of Field JA could not override the actual terms of the legislation under which it was clear that redemption claims did not in fact fall within section 37(7)(a). There was also no support for Eiffel's argument to be found in the analysis of the Privy Council in *Herald*. Furthermore, even if Eiffel's redemption claims were to be treated as if they fell within section 37(7), Eiffel had not attempted to explain how the priority rules in section 37(7)(b) applied such that its claims would have priority over the Misrepresentation.

251. The JOLs noted that the Privy Council in *Herald* had found the question of the relationship between section 37(7) and section 49(g), and the proper interpretation of section 37(7)(b)(i) and the proviso at the end of subsection 37 ("*but subject to that, any such amount shall be paid in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members*"), difficult and had not needed to (and did not) decide the point. The following extract from Lord Mance's judgment explains the approach adopted by the Privy Council:

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"32. On that basis, Primeo, as a former member, ranks after creditors who were not formerly members, but ahead of all current members. The claim of a shareholder entitled to enforce terms providing for redemption or purchase to take place before the commencement of winding up would, under section 37(7)(b), rank behind (1) "all other debts and liabilities of the company (other than any due to members in their character as such)"but, subject to that: (2) "in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members."

33. This language raises some questions. Are the references to (1) debts and liabilities "due to members in their character as such" and (2) "amounts due to members in satisfaction of their rights (whether as to capital or income) as members" references to the same subject matter? Are both or either of (1) and (2) references to past and current members? The phrase "members in their character as such" in (1) might be seen as paralleling the later phrase "any member of a company in his character of a member" in section 49(g). But the two are not identical, and it should be borne in mind that ordinary redeemable shares only entered English law through section 45 of the Companies Act 1981, later consolidated as section 159(1) of the Companies Act 1985. Similarities with pre-existing language of the entirely different section 212(1) of the Companies Act may not be as significant as might at first glance appear. Further, the reasoning adopted in English authority on the English equivalent of section 49 shows that the significance of any reference to "member" is highly contextual.

34. If the answer to the questions posed in the previous paragraph is that both (1) and (2) refer to past and current members, the (on its face incongruous) result would be that section 37(7) claimants, who had not (due to the company's default) achieved redemption but were entitled to enforce it in the winding up would rank higher in priority than those like Primeo, who had achieved redemption, but had simply not been paid. The Board cannot contemplate such a result as the intended or actual effect of sections 37(7) and 49(g).

35. There are two alternative possibilities. One is to read both (1) and (2) as referring only to current members. The effect then is that section 37(7) claimants will, pursuant to (1), rank behind claimants like Primeo falling within section 49(g). That would not be incongruous. On the other hand, the Court of Appeal took a different view, considering, without detailed explanation, that claims such as Primeo's would rank equally with those of any section 37(7) claimants (see CA judgment, para 55). This could be achieved by reading (1) as referring to former as well as current members, but (2) as referring only to current members. This would involve reading in different senses two references to "members" in the same subsection, the latter of which ("members as … members") might or might not be seen as echoing, rather than differing from, the earlier ("members in their character as such"). However, the Board itself heard no detailed submissions on this possibility, and prefers in the circumstances to say no more Page 24 on the question of priorities as between section 49(g) and section 37(7) claimants.

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The likelihood in practice of successful section 37(7) claimants may well also be slight."

252. The JOLs also noted that in *Centaur,* there was competition between redeemed shareholders who had not been paid their redemption proceeds and the claims of continuing shareholders who had debts (in for fixed returns of dividends due in respect to their shares). The joint official liquidators argued that as both the redemption proceeds and the other debt claims by members for debts owing to them in their capacity as members were all liabilities of the company payable to them in their capacity as a member, they should be characterised in the same class of the distribution waterfall. What they were saying was that the unpaid redemption claims and other debts due to shareholders in their capacity as such all ranked in the same way, under 49(g) and, when the question of the relationship between section 37(7) and section 49(g) was raised before Mangatal J, the learned judge had, reasonably the JOLs submitted, concluded that she did not need to deal with it. She had said (at [179]) that *"…the waterfall in section 37(7) and its interaction with the balance of the* ***[Companies Act]*** *is sufficiently uncertain for it to be reasonable for the Court not to have regard to it unless a liquidator is dealing with claims within that subsection (which I have been told is not the case here)*." So she considered that where there the Court was not considering a claim falling within section 37(7) as was the position in that case and as is the position in this case, it was not necessary to resolve the difficult question of the relative priority of a claim which does fall within 37(7) to one that falls within 49(g). Her decision was set out at [180] where she said that "*On this basis, (though the question is obviously a difficult one), I consider that there remains no statutory or common law based on which to distinguish Shareholder creditor Claims within the distribution waterfall, and therefore both Redemption claims and Shareholder crystallised debt claim should fall within Class 2 of the JOLs' distribution waterfall*."

The Priority Point - discussion and decision

The ranking of the Misrepresentation Claims

253. I accept Eiffel's submissions on this issue (subject to some qualifications). I prefer and would follow the approach taken by Lord Browne-Wilkinson in *Soden*.

254. It seems to me that section 49(g) is to be understood and interpreted as regulating the right of shareholders to prove in a winding up so as to give effect to and ensure respect of the Maintenance of Capital Rule (I note that Lord Browne-Wilkinson in *Soden* said that the "*rationale of [section 74(2)(f)] is to ensure that the rights of members as such do not compete with the rights of the general body of creditors*" and that even in the Court of Appeal in *Soden,* it was accepted that "*the underlying rationale of section 74(2)(f) is the principle of the maintenance of capital ..*" albeit that "*the legislature has imposed limiting conditions by requiring the sum due to the member to be so due in his character of a member by way of dividends, profits or otherwise*"). The claims of shareholders relating to or derived from their contribution of capital cannot compete with and must rank after the claims of non-member creditors. The damages claims of holders of redeemable preference shares must, in my view, be characterised and treated as claims relating to or derived from their contribution of capital.

255. I have already explained that I consider that the damages claim by original holders of redeemable preference shares provides them with compensation for (and to that extent can be said to represent), the value of what they paid on subscription (as the JOLs had submitted was the proper approach when arguing that admitting a claim for such damages was in substance a payment of premium on redemption and did not involve an impermissible return of capital). They are therefore seeking to recover a sum representing their capital contribution. In the absence of rescission, they remain a shareholder and receive back the value of what they paid for the shares. To allow a claim for damages for misrepresentation made by the company inducing the subscription for shares in competition with the general body of creditors would, in substance, result in a return of capital.

256. It seems to me that Mr Potts QC was right, but only in the context of a shareholder who has subscribed for his/her shares, when he submitted in *Soden* in the passage quoted at [224] above that "… *a claim is maintained in the character of a member where the claimant seeks to recover from the company the price which he has paid for his shares on the basis that such shares are not worth what they were warranted or represented by the company to be worth. The claimant who is induced to acquire his shares by*

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subscription falls within the class of those who are not allowed to compete with general creditors."

257. Lord Browne-Wilkinson's analysis at pages 322-327 of his judgment in *Soden*, quoted at [224] above, seems to me to be correct. It also seems to me that Mr Justice Robert Walker at first instance in *Soden* (a judge whose reasoning carries substantial weight) was right when he said that the right approach was to distinguish between a claim which is "*characteristically a member's claim*" and a claim which happens to be made by a member. The former, he said, must be a claim directly relating to the contractual nexus between a company and its members and between members amongst themselves. He called that nexus "*the corporate nexus*" and said at [1995] 1 B.C.L.C. 686 at, 698-699:

> "*Ultimately the point comes down to whether a claim made by an open market purchaser of shares in a company (as opposed to an original subscriber or allottee), the claim being based on negligent misrepresentation by the company as to its assets, is sufficiently closely related to the corporate nexus as to be characteristically a member's claim. Addlestone and Webb Distributors were both claims by original members. The claimants were complaining of the very transaction under which, by becoming members, they had contributed part of the company's capital…*"

258. It also seems to me that the following passage in the majority judgment in *Webb* (at page 408c-d) reflects the correct analysis (underlining added):

> *"But, in the present case, the members seek to prove in the liquidation damages which amount to the purchase price of their shares, <u>which is a sum directly related to their shareholding</u>. Moreover, they sue as members, retaining the shares to which they were entitled by virtue of entry into the agreement and they seek to recover damages because the shares are not what they were represented to be. Accordingly, the claim falls within the area which section 360(1)(k) seeks to regulate: <u>the protection of creditors by maintaining the capital of the company.</u>"*

259. I accept that the Court of Appeal in *Soden* had their doubts and took a narrower view of the proper construction of section 74(2)(f). Peter Gibson LJ said that (at page 317) "*We doubt if it is right to describe a member claiming damages for misrepresentation or breach of a contractual warranty when induced to subscribe for shares as being entitled to the damages in his character as a member as his claim does not arise from a right*

which is part of the bundle of rights and obligations which make up his shares, though we acknowledge it has a relation to what the judge called the corporate nexus."

260. This focus on the right upon which the cause of action is based reflects the analysis of both Justice Hayne and Chief Justice Gleeson in *Sons of Gwalia*. I have already set out (at [242] and [243] above) the key passages from the judgment of Justice Hayne (at [202]-[206] of his judgment) which are relied on by the JOLs. Justice Hayne considered (see [203]) that in order to decide whether a claim by a member was within section 563A of the 2001 Act it was necessary to decide whether "*the obligation which the member seeks to enforce is an obligation to members*" (by which I think he means members generally) under the statute or corporation constitution. He noted that his view on the operation of the section "*was not expressed in the terms used in Soden*" and omitted to cover what Lord Browne-Wilkinson called "*negative claims … based upon having paid money to the company under the statutory contract which the member says that he is entitled to have rescinded by way of compensation for misrepresentation or breach of contract*" (see [204]). Justice Hayne's reasoning for not treating such claims as covered by section 563A is then set out at [205]. He says that where money is paid to the company to create the relationship of member the company's obligation to pay damages for fraudulent misrepresentation inducing subscription the cause of action is based on the company's misconduct so that the company's obligation is not founded upon the legislative prescription of the rights and duties of members. There is no legislation, he says, which gives subscribing members (as members) remedies for deceit and the company's obligation "*stands altogether apart from any obligation created by the 2001 Act*" (see [206]). Chief Justice Gleeson also says (at 31]) that the key issue is whether the misrepresentation claims are "*founded upon any rights he obtained or obligation he incurred by virtue of*" the claimant's membership. This construction, if applied to section 49(g), seems to me to be too narrow. The cause of action in deceit relates to the shareholder's continuing rights as a member (since he/she is unable to rescind the subscription contract and remains a member) and seeks compensation calculated by reference to the amounts subscribed as capital. He/she is not claiming that he/she has never been a member but has suffered loss as a result of dealings with the company. The substance of the claim, as I have said, is to recover the value and financial equivalent of the shareholders' capital contribution, which contribution is an obligation derived from the company's constitution and statute and arises because of his/her status as a member.

In any event, adopting a purposive construction of section 49(g), it seems to me that the reasoning of Lord Browne-Wilkinson and Robert Walker J is to be preferred and fits with the legislative scheme and purpose of the Companies Act.

The ranking of claims by the Late Redeemers (redemption creditors)

261. I accept the JOLs' submissions on this issue.

262. Eiffel argues that the redemption creditors rank ahead of all other shareholders who have claims subject to section 49(g) including the Misrepresentation Claimants and of unredeemed holders of redeemable shares with rights under section 37(7)(a).

263. Eiffel's main point seems to be that this conclusion follows from the conversion of holders of redeemable shares into creditors upon giving notice to redeem. This status means that in the "*final adjustment of the rights of the contributions amongst themselves*" they are entitled to a higher ranking than those who remain shareholders at the date of the winding up. Their claims should only be subordinated to those of non-member creditors. Being creditors, and having become creditors before the commencement of the winding up, they are entitled to a superior ranking and status to that of mere shareholders. Eiffel says that the priority of the redemption creditors' claims would then be the same as the outcome of a successful claim made under section 37(7)(a), which ranks ahead of other shareholder claims by virtue of section 37(7)(b).

264. I do not accept that this argument justifies giving the redemption creditors, or treating them as having, priority over the Misrepresentation Claimants. Eiffel's analysis does not apply to the Misrepresentation Claimants. The Misrepresentation Claimants' cause of action in deceit arose prior to the winding up and to that extent they were also creditors before the commencement of the winding up. I do not accept that the adjustment between member claims referred to in section 49(g) requires or permits the Court to order that the Late Redeemers rank and should be paid ahead of the Misrepresentation Claimants. Once the external non-member creditor claims have been paid in full both the Late Redeemers and the Misrepresentation Claimants are member creditors in respect of liabilities owing by DLIFF. The fact that the Late Redeemers gave notice to redeem prior to the commencement of the winding up does not justify such priority. The time at which the

shareholder became a creditor, provided that they were a creditor before winding up, does not govern priorities (if timing were key, it could be said that the Misrepresentation Claimants' cause of action in deceit arose and was complete before the shareholders who had given notice to redeem became creditors, depending on when the Misrepresentation Claimants were able to say that they had suffered damage).

265. It seems to me that *Somers* does not support Eiffel's case. In *Somers,* four shareholders who had given notice of redemption prior to the BVI winding up of a mutual fund company claimed that they should rank ahead of the shareholders who had not done so. The trial judge had held that the claims of the redeemed members and of the continuing members ranked *pari passu* but the Eastern Caribbean Supreme Court in the Court of Appeal (in a judgment of Mitchell JA) allowed an appeal and held that the redeemed members, as deferred creditors within section 197, ranked ahead of the continuing members and must be paid before any surplus was distributed to those continuing members in the winding up. It was established law (see [20]) that a redeemed member was a creditor in respect of his redemption payment and the Court of Appeal held that section 197 (and sections 9 and 12) of the 2003 Act could not be interpreted as overruling this right. Section 197 only indicated that redeemed members could not rank *pari passu* with outside creditors and were therefore deferred to them. There was nothing in the 2003 Act that provided for redeemed members to rank equally with continuing members "*by virtue of any adjustment or any other provision*." The statements (again at [20]) that "*Any adjustment must give higher priority to former members who have become creditors as a result of a redemption than to mere continuing members. To do otherwise fails to give any weight to their rights as creditors rather than member*" must be read in this context. Mitchell JA said (at [21]) that "*Section 197 lays out a general rule that deferred creditors may not claim as ordinary unsecured creditors but with the proviso that their claims will be dealt with in the adjustment between members and former members under the second half of section 197, i.e. after the ordinary unsecured creditors have been paid in full*." Section 197 was therefore interpreted as having the same effect as section 49(g) and the process of adjusting the rights of members *inter se* was under section 197 and section 49(g) the relevant mechanism for giving effect to the priority of redeemed members as creditors over ordinary shareholders. There is no suggestion or basis for concluding that the BVI Court of Appeal relied on or sought to lay down a principle that redeemed members (redemption creditors) must always have priority over all other members, even

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members who are given special statutory rights such as those established by section 37(7). Field JA only referred to *Somers* in *Herald* for the proposition that redemption creditors rank ahead of holders of shares without redemption rights ("*As Mitchell, J.A. said in reference to s.197 of the BVI Insolvency Act in the Somers Dublin Ltd. decision, any adjustment within s.197 must give higher priority to former members who have become creditors as a result of a redemption than to mere continuing members*").

266. The JOLs, as I have noted, have said that there will in this case be no shareholders with rights under section 37(7) (so that there is no competition between the redemption creditors and unredeemed preference shareholders with rights under that subsection) but since Eiffel relied on the operation of this sub-section and I heard arguments on the question of the relationship between sections 37(7)(b) and 49(g), I shall make the following comments.

267. It seems to me that Field JA at [55] in *Herald* was simply saying that the ranking provided for under section 37(7)(b) and section 49(g) is the same in that under both provisions the holders of the redeemable shares are subordinated to the claims of non-member creditors. I do not consider that he was seeking to go beyond this and to analyse or decide the relative ranking of a claim subject to section 49(g) (the claim which was being considered by the Court in that case) and a claim under section 37(7) (albeit that Lord Mance appears to have thought that Field JA did). He only referred (in [55]) to section 37(7) to make the point that the outcome of applying section 49(g) in the manner he considered to be appropriate (namely that redemption creditors would rank after non-member creditors) would be the same as the outcome under section 37(7) (where claims to the redemption price covered by and under section 37(7)(a) would also rank only after non-member creditor claims). This was, as he said, in response to the appellant's argument that "*it cannot have been intended that shareholders of shares redeemed under the articles without payment of the redemption proceeds could claim in the company's liquidation otherwise than under s.37(7)(a) because the outcome of such a claim would see the claimants ranking pari passu with the outside creditors*."

268. The problem is that section 37(7)(b) and section 49(g) operate in parallel and the Companies Act does not deal with how they interrelate. Section 37(7)(b) stipulates that the sums due on redemption are only payable after "*all other debts and liabilities of the*

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company (other than any due to members in their character as such)" but "*in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members*." Section 49(g) stipulates that the sums due on redemption are not to be treated as ("*deemed to be*") a debt payable in competition with any non-member creditor but any such sum may be taken into account for the purposes of the final adjustment of the rights of the contributories amongst themselves.

269. The Privy Council rejected a construction of section 37(7)(b) that resulted in unredeemed preference shareholders ranking higher in priority than preference shareholders who had achieved redemption but had simply not been paid (which must be correct) but left open the possibility that (a) the unredeemed preference shareholders (being section 37(7) claimants) would rank behind the redeemed shareholders falling within section 49(g) (which they considered would not be incongruous) or (b) that the claims of both categories (both the redeemed preference shareholders with claims subject to section 49(g) and the unredeemed shareholders with rights under section 37(7)) would rank *pari passu* as the Privy Council thought that the Court of Appeal had held to be the case).

270. Sections 37(7) and 49(g) take effect according to their terms as follows:

(a). in terms of subordination, the special category of unredeemed preference shareholders are not (under section 37(7)(b)) explicitly subordinated to the redeemed preference shareholders (the latter are carved out from the subordination in section 37(7)(b)(i) as they are owed debts due to them as members).

(b). in terms of subordination, the redeemed preference shareholders who have given notice to redeem before the winding up are not (under section 49(g)) explicitly subordinated to the unredeemed preference shareholders with rights under section 37(7)(a) (because section 49(g) limits the subordination to the claims of non-member creditors).

(c). in terms of priority, the deferred debt owed to the redemption creditors "*may*" under section 49(g) "*be taken into account for the purposes of the final adjustment of the rights of the contributories amongst themselves*."

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(d). in terms of priority, the redemption price due to the unredeemed preference shareholders with rights under section 37(7)(a) is to "*be paid in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income as members)*."

271. Lord Mance summarised the construction conundrum to which these provisions give rise and in particular whether it was intended that the unredeemed preference shareholders with rights under section 37(7)(a) are to be subordinated to the redemption creditors because the latter do not have claims as "*members in their character as such*" (or whether it was intended that redemption creditors should be given priority and a higher ranking in the final adjustment of the rights of the contributories amongst themselves, as referred to in section 49(g)).

272. I am inclined to think, but do not need to decide, that the legislation intended to give both sets of rights *pari passu* treatment in circumstances where the legislation permits (some) holders of redeemable shares to enforce their right to be paid the redemption price despite the commencement of the winding up (and to that extent treats them as being able to exercise their right to become and be paid as creditors) and stipulates that these rights and the rights of redemption creditors are both subordinated to non-member creditors but does not go further and state that the section 37(7)(a) rights are to rank after the rights of redemption creditors.

273. It is true that the redemption creditors have become creditors before the winding up and that the unredeemed shareholders with section 37(7)(a) rights are not creditors at the commencement of the winding up. This is not insignificant and does weigh in favour of giving the redemption creditors priority. But their relative ranking has to be determined by reference to and in light of the statutory regime. The effect of section 37(7)(a) is, as I have said, to treat them as entitled to enforce their right to become creditors and therefore treats them as equivalent to creditors.

274. This construction would put shareholders who have redeemed before the winding up in the same position and give them the same ranking as the limited class of unredeemed shareholders who come within section 37, namely shareholders with redeemable preference shares which provided for redemption to take place prior to or on the date of

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the commencement of the winding up and who satisfy the requirements of section 37(a)(ii) (that the company could lawfully have made a distribution equal to the redemption price for the shares at that date). They are a limited class whose redemption was due to take place before the commencement of the winding up in circumstances where the company was permitted to make the distribution in the period up to the commencement of the winding up. I can see that this approach limits the benefits to be derived from giving notice of redemption before the winding up but only with respect to a very small class who were otherwise entitled to redeem and receive the redemption price (so that giving notice to redeem retains substantial advantages). It can however be said to avoid the unfairness of differentiating between those who did give notice and those whose shares were to be redeemed before the winding up at a time when the company was permitted to pay over the redemption price. This approach also has the merits of being consistent with the decision of Justice Mangatal in *Centaur* (which for the reasons I have given when reviewing Eiffel's submissions, seems to me to produce the right result) and with Lord Mance's understanding of the approach approved by the Court of Appeal in *Herald*.

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The Hon. Mr Justice Segal
Judge of the Grand Court, Cayman Islands
13 March 2024