

IN THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION

FSD No. 38 of 2009 (AJEF)

Before the Honourable Mr Justice Andrew J. Jones QC
In Chambers, 19 November 2014



IN THE MATTER OF THE COMPANIES LAW (2013 REVISION)

AND

IN THE MATTER OF PALM BEACH OFFSHORE LTD (IN OFFICIAL LIQUIDATION)

Appearances :

Mr Lance Ashworth QC instructed by Mr John Harris of Higgs & Johnson for the Appellant

Mr Guy Manning and Mr Mark Goodman of Campbells for the Joint Official Liquidators of the Company

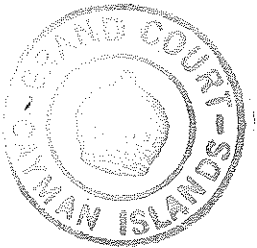
REASONS

1. This is an appeal against the rejection by the Joint Official Liquidators of a proof of debt filed by Fortis Prime Fund Solutions Custodial Services (Ireland) Limited by which it claimed US\$8 million, being the sum payable in respect of a redemption of shares in the Company. Fortis was acting as custodian and has in fact assigned its interest to its client, SFR Holdings Ltd, but it will be convenient to continuing to refer to the appellant as "Fortis". It served a valid redemption notice requiring the Company to redeem on the 31 August 2008 redemption date that number of shares which would result in the payment of redemption proceeds in the sum of US\$8 million. Fortis was the registered owner of 22,953.1059 shares¹ at that time, representing 6.6% of the Company's total issued share capital. The Company reported an NAV of \$1,477.3094 per share in respect of the 31 August 2008 valuation date and on 4 September 2008 its administrator issued a *Shareholder's Account Statement* reflecting the redemption of 5,415.2502 shares for a value of \$8 million.
2. The Company was one of a number of onshore and offshore investment funds promoted and managed by Palm Beach Capital Management LLC, a company wholly owned and

¹ The Company in fact issued two classes of shares but, for the purposes of the issue which the Court has to decide, nothing turns on the fact that Fortis held Class A, Series 0904 shares.

controlled by Mr Bruce Prévost and Mr David Harrold. The Company's board of directors comprised Messrs Prévost and Harrold and two independent directors whose services were provided by an independent professional service provider.

3. Practically the whole of the Company's assets were invested in promissory notes issued by a related party called Palm Beach Finance II, LP ("PBFII"), which in turn invested in secured promissory notes issued by Petters Company Inc ("Petters"), which was supposedly engaged in the business of financing the inventory of retailers of branded household, sporting and electronic goods. In fact Petters was an enormous *Ponzi scheme* perpetrated by Mr Thomas Petters who is now serving a lengthy sentence of imprisonment in the United States.
4. The Company's balance sheet as at 31 August 2008 reflected assets of approximately \$513m and liabilities of approximately \$2m. The investment assets comprised promissory notes issued by PBFII having a reported value of \$512.5m. It is now known that this asset was worthless. The only other assets were cash of about \$296,266 and pre-paid management fees of \$409,477. The liabilities comprised accrued fees of about \$900,000 and redemption payables of about \$1.1m. Prima facie, it follows that the Company was insolvent on a balance sheet test, both before and immediately after the redemption of Fortis's shares, although it might be said that it had contingent assets representing potential causes of action for breach of contract and/or breach of fiduciary duty and/or negligence against some of its service providers.
5. The Petters *Ponzi* scheme came to light in the last week of September 2008. On 29 September the Company's board of directors resolved to suspend the calculation of NAV, thereby suspending subscriptions and redemptions. At that point the directors recognised that the Company's only realisable asset was the balance of approximately \$250,000 then standing to the credit of its bank account. On 3 October 2008 that deposit was frozen by an order of the United States District Court for the District of Minnesota and it remains frozen to this day. On 27 October 2008 the directors presented a winding up petition in the name of the Company on grounds of insolvency and a winding up order was made on 5 November 2008, when Messrs Geoffrey Varga and Neil Morris of Kinetic Partners (Cayman) limited were appointed as official liquidators. Mr Morris was subsequently replaced by Mr Mark Longbottom.
6. Having entered into a litigation funding agreement with an outside funder, the Liquidators were able to commence legal proceedings against the directors and other service providers which ultimately resulted in negotiated settlements. The final outcome is that a sum of approximately \$3.4m, net after payment of liquidation expenses and the funder's share of the litigation proceeds, is currently available for distribution to creditors and shareholders. Only one creditor claim (in the sum of \$44,957.84) has been admitted to proof. All the other



creditor claims were rejected and, except in the case of Fortis, the time for appealing has expired.

7. Assuming that the redemption of Fortis' shares took effect on 31 August 2008, the Liquidators rejected its creditor claim on the ground that it is unenforceable under section 37(7)(a)(ii) of the Companies Law because the Company could not, at any time during the period between the date of the redemption and the date on which the liquidation commenced, have lawfully made a distribution equal in value to the redemption price of \$8m because it was insolvent applying a balance sheet test. The effect of sections 34(2) and/or 37(6) is that a distribution to shareholders (whether paid out of capital or share premium) is unlawful if made at a time when the Company is unable to pay its debts as they fall due in the ordinary course of business. Assuming that the promissory notes were worthless, as in fact turned out to be the case, the realisable value of the assets recorded in the Company's balance sheet was less than the amount of its recorded liabilities at all material times. Accordingly, the priority afforded by section 37(7) is lost and the shares subject to the redemption are to be treated as unredeemed in the liquidation. It would follow that Fortis is now entitled to its pro rata share (6.6%) of the surplus assets available for distribution to the shareholders after payment of \$44,957.84 in respect of the sole creditor claim. That was the basis upon which the Liquidators rejected Fortis' creditor claim.
8. Fortis' appeal rests upon the following propositions. First, Mr Ashworth submits that upon a true construction of the Company's articles of association, interpreted and applied in accordance with the principles laid down by the Privy Council in *Culross Global SPC Limited -v- Strategic Turnaround Master Partnership Limited* 2010(2) CILR 364, the relevant number of Fortis's shares (fixed at 5,415.2502 shares) were redeemed and therefore cancelled on 31 August 2008, whereupon Fortis became a creditor for an amount of \$8m. Second, it is said that upon its true construction, section 37(7)(a)(ii) applies only to shares which have *not* been redeemed as at the commencement of the winding up. It is said that the section only comes into play in circumstances where a redemption notice has been served but not acted upon by the Company. As I understand it, the argument is that the only purpose and effect of this provision is to prevent a shareholder from enforcing a redemption notice which was validly served but not acted upon by the company before the commencement of its liquidation. Third, Mr Ashworth argues that even if the Company was *in fact* insolvent on a balance sheet test both immediately before and after the redemption took effect on 31 August 2008 (about which no admission is made), the redemption is nevertheless enforceable in the liquidation (to the disadvantage of ordinary unsecured creditors) if it can be said that the Company complied, in good faith, with the redemption provisions contained in its articles of association. In this regard it is relevant to note that the Company's articles of association contain the usual provision that "Determinations of Net Asset Value made by on behalf or on behalf of the Directors hereunder in good faith shall be binding on all parties concerned" (Article 12.4). If Mr Ashworth's interpretation of section 37(7)(a)(ii) is right, the result is that a redemption of shares done in good faith at a time when, unknown to its directors and managers, the Company is in fact insolvent is



nevertheless enforceable as against the ordinary unsecured creditors in an insolvent liquidation.

9. The points of law raised by Mr Ashworth in this case are obviously important but I am not required to make any ruling because, on the day before the hearing, Mr Manning abandoned the basis upon which the proof of debt had been rejected and sought to oppose the appeal on other grounds. This surprising turn of events came about in response to a decision in *RMF Market Neutral Strategies (Master) Limited –v- DD Growth Premium 2X Fund (In Official Liquidation)* published on 17 November 2014, just two days before the hearing. Mr Manning understands the Chief Justice to be saying that “a redemption payment out of share premium or capital would be lawful, irrespective of the company’s solvency at the time of the payment, provided only that the payment was authorised by the articles” (Supplemental Skeleton Argument paragraph 8). In any event, it is not necessary for me to analyse this decision because Mr Manning elected to put the Liquidators’ case in three new and quite different ways.
10. First, he argues that as a matter of contract the determination of the NAV published by the Company’s administrator on 4 September 2008 must be regarded as provisional, with the result that it is still open to the Liquidators to determine a true NAV with the benefit of hindsight for the purposes of determining how many shares would need to be redeemed in order to produce proceeds of \$8m. Article 12.1 provides that “The Net Asset Value of the Company shall be calculated in accordance with the Offering Memorandum as at each relevant Valuation Date...”. I accept that this provision has the effect of incorporating the applicable provisions of the offering memorandum (which is actually called a Private Offering Circular) into the Company’s articles of association. The relevant provision states that –

“Payment of 95% of the redemption amount for Shares so redeemed will be made not later than 30 business days following such redemption date, and the remaining 5% together with interest at the rates payable from time to time on the Fund’s cash balances, will be paid within 30 days pending final calculation of the redemption amount (which may be after completion of the next audit).”

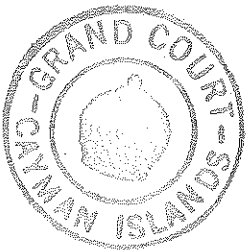
I think that the effect of this provision is clear. The initial determination of the NAV notified to Fortis on 4 September 2008 was provisional. It was liable to be changed and the final calculation might not be done until after completion of the next audit which would not have happened until the following year because the Company has a 31 December financial year end. This is the interpretation in fact adopted by the Company. The *Shareholder’s Account Statement* issued to Fortis on 4 September 2004 records the redemption transaction at \$1.477.3094 per share but expressly states that it is a “Pending transaction where shares and amounts are subject to change”. In my judgment, having now conceded that Fortis should be regarded as a creditor, it is open to the Company (acting by its Liquidators) to make a final determination of the true NAV as at the applicable valuation date. With the benefit of hindsight, there is no doubt that the promissory notes should be valued at nil. However, there would appear to be scope for arguing that the causes of action which ultimately



produced a return should be treated as contingent assets existing as at the valuation date and that some value ought to be ascribed to them. There must also be scope for arguing that the investment manager was in breach of contract and/or breach of fiduciary duty with the result that accrued fees should be written off. This is a matter for expert evidence.

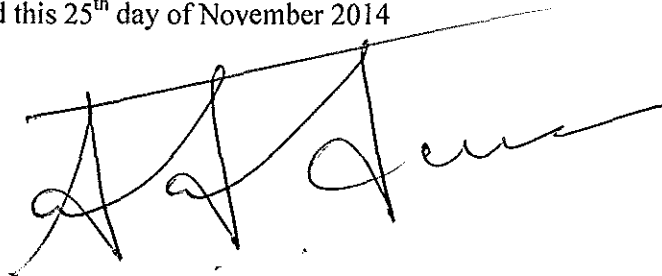
11. Secondly and alternatively, Mr Manning now seeks to argue that the provisional determination of the NAV is not binding on the parties because it was not made in good faith. The only evidence currently before the Court in support of this contention is the *Plea Agreement and Sentencing Stipulations* signed by Messrs Prévost and Harrold on 21 April 2011 in the context of the criminal proceedings brought against them in the United States (the "Stipulations"). These Stipulations constitute formal written admissions made with the benefit of legal advice on the basis of which they both pleaded guilty to securities fraud in connection with the Company and the other onshore and offshore companies managed by them. They were both sentenced to lengthy terms of imprisonment. These Stipulations constitute admissions by both men that, from February 2008 onwards, they made representations to "Palm Beach investors" (which is defined to include the Company's shareholders) about the way in which the Petters' "business" was being operated which they knew to be false. The Stipulations appear to constitute an admission that they made false representations to investors about the fact that Petters had defaulted on its obligations and concealed that the fact that they had entered into a "note swop" transaction which appears to me to be a mechanism for dishonestly dressing up the balance sheets of all the investment companies, including PBFII and the Company. Whilst it is right to say that they deny having known that Petters was a *Ponzi* scheme, the Stipulations are evidence that they knew that it was in financial difficulty and that they dishonestly concealed this fact from the Company's shareholders. It seems to me that these admissions constitute an evidential foundation upon which the Liquidators might properly allege that the NAV calculation for the August 2008 valuation date was not done in good faith. There is no suggestion that the administrator or the independent directors were privy to the same knowledge as Messrs Prévost and Harrold, but it may be reasonable to infer that if they mislead investors they must have misled the administrator and the independent directors. There is a basis upon which to argue that the knowledge of Messrs Prévost and Harrold should be imputed to the Company. In these circumstances, I came to the conclusion that the Liquidators should be given an opportunity to adduce further evidence in support of the allegation that the reported NAV is not binding and enforceable against the Company on the basis that it was not made in good faith.

12. Mr Manning's third argument is that the Liquidators are entitled to rectify the share register pursuant to section 112 of the Companies Law and CWR Order 12. I did not find it necessary to make any ruling on this point for the purposes of reaching the conclusion that I should adjourn this appeal, part heard, in order to give the Liquidators an opportunity to adduce evidence in support of the first two arguments.



13. Mr Manning is not in a position to make good on either of his arguments without adducing further evidence and I concluded that the interests of justice would be best served by adjourning the hearing of the appeal to allow this to be done. I have not overlooked the fact that Mr Manning made a third argument, namely that the Liquidators are entitled to rectify the share register pursuant to section 112 and CWR order 12, but I did not find it necessary to make any ruling or take view about the merits of this argument in order to come to the conclusion that I should adjourn the hearing. Having pronounced my decision, the parties agreed that the Liquidators' additional evidence should be served by Friday 9 January and that any evidence in reply should be served by Friday 30 January 2015.
14. I concluded that the Liquidators are entitled to have their costs of the hearing paid out of the assets of the Company in any event pursuant to the provisions of CWR Order 16 r.19(1) and/or Order 24, rule 10(i). Fortis' costs will be reserved pending the final outcome of the appeal.

Dated this 25th day of November 2014



The Honourable Mr Justice Andrew J. Jones QC

