The Judicial Committee of the Privy Council as an important source of financial services jurisprudence

The 9th Annual P.R.I.M.E. Finance Conference

The Peace Palace, The Hague, The Netherlands

Lady Arden, Justice of the Supreme Court of the United Kingdom, at

3 February 2020

Role of the Privy Council

The Judicial Committee of The Privy Council (JCPC) is a unique body. It is the court of final appeal for the UK overseas territories and Crown dependencies, and for those Commonwealth countries that have retained the appeal to Her Majesty in Council or, in the case of Republics, to the Judicial Committee. The countries include British Virgin Islands, Cayman Islands, The Bahamas, Bermuda and Antigua and Barbuda.

The JCPC has heard appeals from overseas jurisdictions for many centuries, starting perhaps with appeals from the Channel Islands, which could not come before the common law courts of England and Wales. It may, if the case so requires, in effect act as a constitutional court for the country in question. The countries which send appeals often have very different legal systems and laws but in relation to companies, the law is often derived from the early British statutes in the field, such as the Companies Act 1862. I hasten to say that the countries involved have often sought to update any early British legislation to meet the demands of modern commerce.

The JCPC is not part of the UK judicial system. Instead it is part of the system of the country from which the appeal comes. In this way the JCPC has some of the features of an international court. Although it is called a committee it is a court of law. In relation to those countries which recognise the Queen as Head of State, the conclusions on an appeal are formally an advice and recommendation to the Sovereign. They are technically an opinion rather than a judgment, and an order is made by the Queen in Council to give legal effect to the recommendation. The judges who sit in the JCPC are normally Justices of the Supreme Court of the United Kingdom.

In the last five years in particular, the JCPC has heard a significant number of appeals arising from the financial services industry, reflecting the importance in today's world in commercial terms of the countries sending appeals. These appeals have produced a useful body of law which deserves to be considered as a new area of activity for the JCPC. Sometimes the importance of the case law decided by the JCPC is overlooked, which is a loss. I cannot comprehensively survey the cases which it has decided in this field, but I hope to give you a flavour of some of the issues with which it has had to deal.

Determining the fair value of shares for the purpose of appraisal rights

I am going to start with a decision promulgated recently: ***Shanda Games Ltd v Maso Capital Investments Ltd***[1]. This was an appeal from the Cayman Islands and concerned a provision which has recently been inserted into the Companies Law of the Cayman Islands ("CICL") to give shareholders who oppose a merger the right to have their shares bought out at the fair value fixed by the Court. This is, therefore, what in various state corporations laws of the United States is known as an appraisal right.

The factual background was interesting. Shanda was a Cayman Islands company, but it had issued American Depositary shares which were listed in the US on NASDAQ. Shanda was Chinese-controlled. Its business was the manufacture and sale of computer games.

Shanda shares became unpopular with US investors, as did a number of other Chinese stocks listed in the US. Shanda's share price declined, and so its controllers decided to enter into what is known as a "take private" transaction. A group of shareholders would buy the shares of the remaining shareholders and make the company a private one. Of course, those surviving shareholders may subsequently cause the company or a successor company to be listed on a Chinese stock exchange and if they do that they may make a substantial profit.

A number of shareholders in Shanda whose shares were proposed to be bought out wanted to use the appraisal right to get a better price for their shares than they got under the merger

[1] [2020] UKPC 2.

transaction. So they gave notice to exercise their appraisal right. They could not agree a figure with the company so the courts of the Cayman Islands had to determine "the fair value".

Now there was an interesting difference of view between the first instance decision in the Grand Court and that of the Court of Appeal of the Cayman Islands ("CICA").

The Grand Court held that, as the appraisal right had been based principally on Delaware law, the court should adopt the Delaware courts' approach to valuation and this meant that it had to find the full value of the shares as if there had been a sale or other realisation of all the assets.

The Grand Court was correct about the history of the provision. During the passage of the legislation through the Cayman Islands legislature, the minister had said that the Bill responded to requests from the private sector and reflected guidance from a number of jurisdictions including Delaware.

The Grand Court noted that the Cayman Islands appraisal right followed closely the Delaware provision, although it was not completely identical to it. So it adopted the approach of the Delaware courts which was to give full value, without any minority discount. It found that the shares were worth US$8.34 each – an uplift of 235% on the merger price.

CICA took a different view. It surveyed the other similar provisions under CICL. For instance, there may be a scheme of arrangement. This mechanism is often used to achieve a takeover. The scheme will provide for the cancellation or transfer of the existing shareholders' shares in exchange for consideration – either other shares or cash or a mixture of the two.

Under UK law, and indeed CICL, to be binding, a scheme of arrangement must have been approved by members at a meeting convened by the court by statutory majorities and then approved by the court. Shareholders have no right to be bought out in these circumstances, but they may contend that the price is unfair and that the Court should therefore not approve the scheme.

The UK courts have held in relation to schemes of arrangement that the price is not unfair if it is a price which shareholders acting reasonably could properly approve. So the court does not itself value the shares or seek to establish that the shareholders will receive the full value of their shares. In the absence of special circumstances, the court defers to the negotiated price.

The difference of view between the judge and CICA exposed a fault line in adopting provisions from some other system. Can you transplant them – to use figurative language, "lock, stock and barrel"– or will the provisions, when transplanted, fall to be construed consistently with other provisions of the law into which they are transplanted? Clearly this is a matter which prospective investors will want to know.

The JCPC agreed with CICA on this. The legislature could hardly have intended, by mirroring a Delaware provision, that the provisions should be subject to judicial interpretation from time to time by the Delaware courts or that the provisions should be interpreted in disregard of principles underlying other similar provisions in the CICL. In other words the newly inserted provision had to be interpreted consistently with the other provisions of the CICL and they showed that they were enacted on the basis of a principle that a shareholder should only receive the value of what he had to sell, which was a minority shareholding. He could not get the full value as if there had been a sale of all the assets and a distribution of the proceeds of sale to the relevant shareholders in proportion to the number of shares which they held in the company. This may be contrasted with the benefits which those who acquire the minority's shares get as a result of getting control. The new controllers do not have to share those benefits as such with the minority shareholders.

The experts were agreed on that basis that the value of the shares fixed by the judge had to be reduced by some 23%. Because of the parties' agreement, the JCPC did not have to consider any further question as to what constituted fair value for the purpose of the appraisal provision. Of course, fair value may mean a price specially fixed by the court and representing its view as to the fair value. The court may consider, for instance, that the fact that the shareholders had to sell when otherwise they would have wanted to hold on to their investment in the company is a relevant factor and that they should be compensated for that element of involuntary sale, ie for the fact of expropriation.

When the statute says "fair value" it arguably does not make it clear to whom it must be fair – has it got to be fair to the shareholders seeking appraisal, the remaining shareholders or the company?

Another view might be that the shares are only worth what someone is prepared to pay for them. This is the merger price. Courts may consider that fairness to other shareholders involves giving the merger price weight too.

From this it might follow that, if the price has been carefully negotiated by a committee of unaffiliated directors, with the benefit of full access to information about the company and with the benefit of independent financial or other relevant advice, the fair value of shares is that negotiated price. The courts may find additional reassurance in this negotiated price if there have been competing bids for the company.

Moreover, courts do not normally second-guess the judgment of shareholders on financial matters – and in this instance some shareholders will have found the merger price acceptable. So their approval may be given weight for this reason too.

There may also be the problem that to determine the fair value without reference to the merger price may encourage litigation. It may even encourage people to buy shares with a view to exercising appraisal rights, and this could also have an adverse impact on court resources.

It may also make it difficult to achieve mergers efficiently and have adverse economic consequences: there may be less rationalisation of industries that have become outmoded.

These are some of the difficult issues that may have to be considered in the future and therefore I express no view on them. There may indeed be no one answer to the question of the correct approach to valuation: there may be different answers according to the facts of the case. We shall have to see.

Fall-out from the Madoff affair

There is a cluster of cases that are the product of the collapse of the Bernard L Madoff investment empire. I say "empire" because this was a case of the emperor's new clothes. Mr Madoff led investors and their advisers to believe that his funds were invested in assets of enormous value. In fact it was a scam – there were no underlying assets. Mr Madoff's company, Bernard L Madoff Investment Securities LLC ("BLMIS"), was a Ponzi scheme. It is thought to have been one of the largest Ponzi schemes in history with funds of perhaps as much as US$18 billion having been accepted for investment. Mr Madoff was arrested in 2008 and following his trial and conviction he was sentenced to 150 years in prison for his actions. The collapse of his empire was over ten years ago, but it is still causing ripples in the legal world.

Lord Sumption made an extremely important point in an appeal from the British Virgin Islands, ***Fairfield Sentry Ltd v Migani***[2]. He stated that it is inherent in a Ponzi scheme that those who withdraw their funds before the scheme collapses escape without loss, and quite possibly with substantial fictitious profits. These investors may therefore be called "the winners". Those who remain invested in the funds obtain only a dividend on their investments if they are lucky. They may be called "the losers". We can see the consequences of this analysis in the jurisprudence of the JCPC.

By way of background, BLMIS issued redeemable securities, ie shares which the holders could redeem by giving notice to the company at prices established under the company's articles of association. BLMIS proved immensely popular with the investing public, so many subscriptions were made. The redemption proceeds payable to redeeming shareholders were paid out of newly made subscriptions.

There was also a web of "feeder" funds which gave investors portals into Madoff. Those feeder funds included Fairfield Sentry. People invested in feeder funds which invested in Madoff funds. The feeder funds themselves issued redeemable shares reflecting the underlying value of the

[2][2014] UKPC 9.

investment in the Madoff funds. The information about those underlying values was obtained from BLMIS and not from Fairfield Sentry, and those underlying values were fictitious.

When a person subscribed for these shares or redeemed them, there had to be a calculation of the net asset value of the company. The articles of association of the feeder funds commonly provided that the certificate of the directors of the company given in good faith as to the net asset value was final and conclusive. These certificates were the basis on which shares were issued or redeemed. Investors would receive regular statements showing the value of their investment at particular dates. The difficulty was of course that the values were fictitious.

In *Fairfield Sentry v Migani*, the liquidators of Fairfield Sentry sought to redress the imbalance in favour of the winners by contending that the redemption payments were made in the mistaken belief that the underlying assets were as stated by BLMIS. The liquidator wanted to establish that he could go behind the certificates of valuation given at various points in time by the directors including on redemption.

The JCPC took the view that the directors' certificates confirming the value of the shareholders' investments from time to time, if given in good faith, were final and binding. That was the result of the contract between the feeder fund and its shareholders to be found in the articles of association. It was not suggested that the feeder fund was a party to the fraud perpetrated by Mr Madoff.[3]

The liquidators of feeder funds still sought to redress the balance between shareholders who had redeemed before the discovery of the Madoff fraud at amounts representing overvaluations of their investments (the winners) and those who had not redeemed before the crash (the losers), and who stood to get very much less on a liquidation of their fund.

[3]Cf *Skandinaviska Enskilda Banken AB (Publ) v Conway* [2019] UKPC 36, considered below on another point, where the fraud was effected by the directors who fraudulently inflated the value of the investments. The JCPC distinguished *Fairfield Sentry*.

Pearson v Primeo (no 1)[4] involved yet another Madoff feeder fund, this time Herald Fund SPC. One of its investors was Primeo Fund. The appeal came from the Cayman Islands. Primeo represented shareholders who had given the necessary notice of redemption but who had not actually been paid their redemption monies before Herald exercised its right under the articles of association to suspend the redemption of its redeemable shares.

The liquidator wanted to establish that these shares had not in fact been redeemed so that the redeeming shareholders were not able to claim their redemption monies in the liquidation at the expense of those who had not redeemed. However, the JCPC held that the process had progressed sufficiently so that redemption had been achieved.

The question whether shares had been duly redeemed also arose in another appeal from the Cayman Islands - ***DD Growth Premium 2X Fund v RMF Market Neutral Strategies***.[5] CICL permits redeemable shares to be redeemed out of capital if the company can pay its debts as they fall due in the ordinary course of business immediately after the payment is made. The redeemable shares in this case had a nominal value of US$0.001 and nearly all the redemption proceeds were in respect of the premium payable on redemption over the nominal amount. In this case the company paid the redemption proceeds but the liquidator challenged these payments on the basis that the company could not meet this test because the payments would have rendered the company insolvent. The shareholder's case was that the redemption proceeds were not debts and that the company could pay its debts if those sums were excluded. It was common ground that, if the redemption proceeds had to be taken into account, the company was not able to pay its debts as they fell due.

By a majority of three to two, the JCPC held that in determining whether the company could pay its debts as they fell due, the monies payable to the redeeming shareholders had to be taken into account. The majority held that this applied even if share premium account was used to pay the premium payable on redemption.

[4][2017] UKPC 19.
[5][2017] UKPC 36.

The minority, however, took the view that under CICL the share premium account was not capital. CICL allowed share premium account to be used to pay the premium payable on redemption, and accordingly the shares were not redeemed out of capital.

Further appeals seeking ways of counteracting the advantage to shareholders who achieve redemption before liquidation

The liquidators of mutual funds, including feeder funds, have continued to seek yet further ways of ironing out what is seen as the unfairness that someone is lucky enough to redeem his shares and receive payment in full before it is too late.

This strategy may be driven by the fact that, as I understand it, under US law the liquidators of BLMIS had been able to separate the claims of defrauded private investors from those of professional persons having dealings with BLMIS and give the private investors some priority. In addition, the US courts have been able to approve the adoption of what is called a "net investment" method which permits claims in respect of redeemable securities to be made for the gross amount of the investment less the amounts already received. This is designed to enable the position of winners and losers claiming in the liquidation to be levelled out.

This is not easy to achieve under insolvency laws similar to those of the UK. The starting point is that there is no immediately obvious cause of action available to the liquidator in this situation enabling him to claw back the amounts already lawfully paid to investors. Nor is it immediately obvious that there should be any such cause of action. Some might say that the net investment method amounts (as the saying goes) to robbing Peter to pay Paul. Robbing Peter to pay Paul means using monies that legitimately belong to one person to satisfy the needs of another. An even more serious objection is that it violates a fundamental principle of UK insolvency law that assets are distributed *pari passu*. That principle, the *pari passu* principle, means that, subject to certain established exceptions, creditors of the same rank receive distributions on an equal footing and in proportion to the amounts due to them respectively. And that is inconsistent with any robbing of Peter to pay Paul. On the other hand, if a way would be found through these

issues, investors who had been repaid in full might have to repay to the liquidator sums paid to them.

The question whether a liquidator should be able to depart from the statutory order of distribution arose in ***In the matter of Stanford International Bank Ltd***[6] ("SIB") on appeal from the Court of Appeal of Antigua and Barbuda. This concerned yet another Ponzi scheme, this time brought about by Mr Stanford who ran a bank in Antigua known as SIB. As so often happens his fraud was discovered. SIB went into liquidation in 2009.

The companies legislation of Antigua and Barbuda contained a special provision, namely section 204 of Antigua and Barbuda's International Business Corporations Act, which had been modelled on similar provisions in Canada and elsewhere, enabling a person appointed by the court to bring proceedings for relief where the affairs of the company had been conducted in a manner which was unfairly prejudicial to the interests of any unsecured creditor. This time the redeemable securities were debt obligations and not shares. The liquidator wanted to use section 204 to obtain orders clawing back redemptions made at inflated values in the last period of trading and enabling him to require creditors who had received redemption monies to bring those monies into account before they received any further distribution.

The majority held that a liquidator could not in any circumstances use this special provision because to do so would be inconsistent with the provisions in the same Act for creditors to rank *pari passu*. The minority (including myself) considered that a liquidator could be permitted to proceed under section 204 unless the relief he sought was inconsistent with the *pari passu* principle. That was the position in this case. So this attempt by the liquidator of SIB also failed.

The liquidator in the next appeal, ***Pearson v Primeo Fund (no 2)***[7], sought to use a power conferred on liquidators in his jurisdiction to impose what was effectively a net investment method of distribution. The position was that those who had not redeemed before the liquidation would receive only some 30-40% of the investment in the liquidation whereas those

[6] [2019] UKPC 45.
[7] [2020] UKPC 3.

who redeemed before the liquidation achieved 100% of their claims. The power which the liquidator wanted to use was the power to adjust the rights of contributories (viz shareholders entitled to share in the surplus assets in the liquidation). This power of adjustment is expressly given by CICL in connection with settling the list of contributories.

The JCPC held that this power could not be used to alter the legal rights of the members. In my concurring judgment, I held that the power could be used to enforce any claim of the company against the shareholder, whensoever and howsoever arising. It could (as I saw it) be used to offset any liability of his to the company, provided that the adjustment of the rights of contributories did not go beyond any shareholder's legal rights and liabilities. That conclusion exposed an important area which would be relevant if the liquidator had some other claim against the shareholder. Suppose that the shareholder's shares had not been lawfully redeemed. The claim against the shareholder might not in that event be "shut out" by any directors' certificate as to net asset value and so *Fairfield Sentry* would be distinguishable. The rights of the shareholder to surplus assets could then be adjusted so as to deduct what he owed the company on account of the unlawful redemption. My approach might enable liquidators in some circumstances to inch forward in the disputed area in which they have been so active in trying to find a solution. I have therefore left the door a little bit more open than it was.

Preferences

Finally I wish to mention two important JCPC cases on claims arising out of preferences, that is, out of claims vested in liquidators to set aside pre-liquidation transactions on the grounds that they preferred the creditors who received payment under them. These claims are important because, if they are substantiated, they provide one of the means by which a company's assets which have been disposed of prior to liquidation can be clawed back into its liquidation. By that means, the assets available for distribution in the liquidation can be increased. Both cases also arise out of the exercise by shareholders of their rights to redeem shares.

The first case, ***Skandinaviska Enskilda Banken AB (Publ) v Conway***[8], another appeal from the Cayman Islands, deals with a number of important points, but one of them is of considerable significance to anyone involved in liquidations. The shareholder in question had redeemed its shares and received payment ahead of other shareholders entitled to receive redemption monies. The liquidator contended that the payment to it was an unlawful preference and that the court should set it aside under section 145(1) of CICL. But there was no express statutory right of action for recovery of the monies paid. If there is no statutory right of action to recover money transferred under a transaction which turns out to be a preference or other voidable transaction, the liquidator will have to look to the general law. The JCPC held that, if he brings a restitutionary remedy for the recovery of monies paid under a transaction which is set aside as a preference, the defendant will not be able to rely on the defence of change of position because that would offend the *pari passu* principle described above. This decision therefore precludes reliance on the defence of change of position.

This recognition of the overriding public policy of *pari passu* distribution in an insolvency is most welcome.

The second JCPC case which I wish to mention is an appeal from The Bahamas, ***AWH Fund Ltd v ZCM Asset Holding Co (Bermuda) Ltd***.[9] Here, redeemable shares of AWH, a Bahamian international business company, had been registered in the name of ZCM and they were redeemed within three months of the winding up of AWH. The liquidator contended that the payment was void as an undue or fraudulent preference under the relevant legislative provision, namely section 160 of the International Business Companies Act 2000 of The Bahamas, and he met the merits threshold for service out of the jurisdiction on ZCM, which was based in Bermuda. The JCPC held that section 160 had extraterritorial effect and that the Bahamian court had power to order service of these proceedings out of the jurisdiction. There was sufficient connection between ZCM and The Bahamas because ZCM had taken shares in a Bahamian company. In addition the claim was properly brought against ZCM, although it was

[8][2019] UKPC 36.

[9][2019] UKPC 37.

not the beneficial owner of the shares redeemed. This case is important because the effect of the decision is to increase the reach of the domestic liquidation legislation.

Conclusion

These cases show how mature the systems of the countries from which they came have become in financial services law. They have attracted massive funds for investment. The disputes arising have had to be determined with great care in accordance with the law and in a way which inspires respect for the rule of law. These cases mark a new chapter in the history of the JCPC. Its function on these appeals is to serve the needs of the jurisdictions from which the appeals come. As I have endeavoured to show, the JCPC in turn acquires experience of questions of considerable contemporary importance in the field of financial services.