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UK Privy Council Decision on fund redemption process in Fairfield Sentry Limited

Readers will no doubt be familiar with Bernard L. Madoff's Ponzi scheme perpetuated through his firm Bernard L. Madoff Investment Securities LLC ("**BLMIS**"), his 2009 conviction and the multiplicity of litigation affecting shareholders and former shareholders in what were (although not always described as such) feeder funds invested in BLMIS.

A variety of interesting issues relating to the redemption process of funds arose out of legal actions initiated by the liquidators of Fairfield Sentry Limited ("**Fairfield**"), against persons who had redeemed out of Fairfield prior to the discovery of the Madoff fraud and were eventually dealt with by the UK Privy Council (the "**Privy Council**") on 16 April, 2014. The Privy Council decision can be seen as a clear, sensible and much welcome one, particularly for redeemed former shareholders.

Fairfield Sentry Limited

Fairfield (now in liquidation) was incorporated in the British Virgin Islands as a mutual fund and during the period from 1997 to 2008 it was the single largest investor with BLMIS with estimated investments of approximately US\$7.2 billion. The liquidator of Fairfield initiated a large number of actions against former shareholders who had redeemed prior to the fraud being discovered in an effort to recover amounts paid to them on redemption of their shares on the basis that the redemption amounts were paid in the mistaken belief that the value attributed to the investments in BLMIS

For further information on any of the issues discussed in this article please contact:



Shane Geraghty

DD:+ 353 (0)1 673 1888

shane.geraghty@dilloneustace.ie

were correct, when in fact no such assets ever existed. The liquidator was in effect seeking to have the previously issued Net Asset Value (“NAV”) per share reduced to US\$0 and to have all former shareholders (“**Redeemed Shareholders**”) to return the net proceeds of their redemptions from Fairfield to the liquidator.

A number of affected former shareholders applied to the Commercial Division of the High Court of the British Virgin Islands (the “**Commercial Court**”) on a number of preliminary issues. The Commercial Court considered four preliminary issues in respect of Fairfield, three of which were considered together. These three preliminary issues concerned whether or not certain transaction documents issued to shareholders in Fairfield which recorded the NAV per share or the redemption price upon redemption were binding on Fairfield under its memorandum and articles of association (“**Articles**”) and therefore could be considered ‘certificates’ for the purpose of the Articles (the “**Certificate Issue**”). The fourth preliminary issue concerned whether the defendants had given good consideration when surrendering their shares in return for the redemption proceeds (the “**Good Consideration Issue**”). In the Commercial Court, Bannister J. found that the documents issued by Fairfield which recorded the NAV per share or the redemption price upon redemption were not ‘certificates’ for the purposes of its Articles but did find that shareholders had provided ‘good consideration’ for their shares. The decision of the Commercial Court was subsequently upheld by the East Caribbean Court of Appeal and then appealed by to the Privy Council.

Privy Council Considerations

In assessing the Certificate Issue, the Privy Council looked to the Articles of Fairfield and to the construction and intent of its provisions with respect to the subscription and redemption process. The Privy Council made it clear that the subscription form utilised by all investors in Fairfield when subscribing for shares binds the subscriber to the subscription form and the terms of Fairfield’s Offering Memorandum and Articles. The Privy Council was of the view that the terms governing a shareholders membership of Fairfield and the redemption of its shares were to be found in the Articles. The key question that arose was whether the NAV per share of Fairfield could be revised on the basis that, as the liquidator argued, because no certificate had been issued in accordance with the Articles the NAV per share had been finally determined.

In the ordinary course of its operations, Fairfield’s administrator, Citco Fund Services (Europe) BV (“**Citco**”) had issued and published various documents to all shareholders on a monthly basis which detailed (i) monthly final Net Asset Values; (ii) monthly balance statements including opening and closing NAV per share for each month and a summary of any subscriptions or redemptions made during the relevant month. In addition, Citco provided contract notes in respect of redemptions made from Fairfield. The defendants (i.e. the Redeemed Shareholders) argued that all of these documents issued by Citco, constituted ‘certificates’ for the purposes of the Articles. This argument was not accepted by the Commercial Court.

The Privy Council also had regard to the issue of restitution and in this regard, the Privy Council identified the decision in *Kleinwort Benson Ltd v Lincoln City Council* [199] 2 AC 349 where it was found that the payee of money:

“...cannot be said to have been unjustly enriched if he was entitled to receive the sum paid to him”

Consequently, in the event that shareholders had no entitlement to the amount received or the payment received exceeded the amount owed then Fairfield would have been in a position where it could have sought recovery of the redemption proceeds. Therefore, the importance of valuation of Fairfield became an important matter. The Privy Council addressed the issue of the final determination of the NAV per share and clearly stated that the claim to recover any redemption payments depended on whether Fairfield was bound by the redemption terms to make the redemption payments. This question would be decided by determining whether Fairfield was obliged to pay (i) the true NAV per share based on the information which came to light arising out of the discovery of the Madoff fraud; or (ii) the NAV per share which was determined by the directors of Fairfield at the time of the redemptions made.

In its analysis, the Privy Council reviewed the Articles and found that they set down the method for determining the amount due and the timings of payment to redeeming shareholders and once the NAV per share was ascertained, then redemptions would be made at the finalised redemption price. The importance of the price being definitively finalised was highlighted and the Privy Council stated that any other conclusion was unworkable.

The Privy Council rejected the liquidator’s argument that the final determination of the NAV per share was not completed until a certificate was issued. Importantly, it found that the documents issued by Citco in the ordinary course of Fairfield’s relationship with its shareholders constituted ‘certificates’ for the purposes of the Articles. The Privy Council found that the documents had (i) conveyed information to shareholders from Fairfield; (ii) the documents were issued by Citco under the authority of the directors of Fairfield; and (iii) the documents were intended to be definitive.

In finding the documents issued by Citco constituted ‘certificates’ the Privy Council provided that:

“As a matter of language, a “certificate” ordinarily means (i) a statement in writing, (ii) issued by an authoritative source, which (iii) is communicated by whatever method to a recipient or class of recipient intended to rely on it, and (iv) conveys information, (v) in a form or context that it is intended to be definitive. There is no reason to think that a document must satisfy any further formal requirements, unless its purpose or legal context plainly requires them...”

The Privy Council held that it was essential that the redemption price should be definitive at the time of the transaction and the relevant valuation day and that to suggest otherwise would be to expose redeemed investors to an open-ended liability to repay part of the price received in the event that the assets were subsequently determined to be less than the amount thought at the time of redemption. In addition, any such assessment would leave redeemed shareholders with the open-

ended opportunity to seek recovery in the event that it subsequently transpired that the shares redeemed were worth more than they were redeemed for at the time. The Privy Council found this position to be unacceptable.

Accordingly, the Privy Council overturned the decisions of the Commercial Court and the East Caribbean Court of Appeal on the Certificate Issue and dismissed the appeal on the Good Consideration Issue. In doing so it provided a very significant blow to the liquidators of Fairfield and other liquidators seeking to utilise similar claw-back arguments.

Impact of the decision

The decision is a watershed moment for many investors who invested in Madoff feeder schemes such as Fairfield. It clearly sets down a mark in the sand, especially within Common law jurisdictions, regarding the treatment of investors who in good faith redeemed their shares in investment funds prior to the discovery of fraud. The decision also demonstrates that when considering the constitutional documents (memorandum and articles of association, trust deeds etc.), regard should be had to their plain meaning while taking into account overarching legal principles. It also highlights that operational factors can be relied upon when interpreting such documents (i.e. issuance of 'certificates'). Accordingly, this decision will be of interest not just to those former shareholders of entities such as Fairfield and similar entities but also to promoters and managers of investment funds when they are considering establishing investment funds so as to ensure that there is certainty around the determination of the NAV per share.

While the Privy Council's decision is related to the law of the British Virgin Islands, it will without doubt be cited in any similar cases before Common law courts (including potentially the Irish courts) and indeed may have serious repercussions for many similar cases which have been stayed pending the outcome of the Fairfield decision. It is a very positive judgement for redeemed shareholders in cases such as Fairfield but will obviously be of little comfort to those investors who remained invested in Fairfield at the time of the Madoff fraud discovery.

Author: Shane Geraghty

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DILLON  EUSTACE

Dublin

33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands

Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

Hong Kong

604 6/F Printing House, 6 Duddell Street, Central, Hong Kong. Tel: +852 352 10352.

New York

245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo

12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.

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