

KEY POINTS

- Many investors in open-ended investment funds hold their interests not as registered shareholders but through custodians.
- From the Commonwealth and English authorities, it seems that whilst a customer under a custodian agreement as a non-registered shareholder may bring claims against a company (by joining a trustee shareholder), it may be difficult to mount a derivative suit under traditional rules.
- However, recent cases show that there may be ways around this. If a custodian is in the position of a bare trustee, it seems that beneficial owners can step forward to enforce their rights.

Author Thomas Lowe QC

Vindicating shareholder rights under nominee and custodian agreements

In this article, Thomas Lowe QC considers whether the jurisprudence on claims brought by non-registered shareholders against companies and in the context of derivative claims should apply to the various claims against funds concerned with redemption requests.

It is normally supposed that only registered shareholders can bring proceedings to vindicate rights conferred by their shareholding. This seemingly well-established principle is much less clear cut than it would seem. In many situations this rule operates unfairly and contrary to the commercial expectations of all involved. For example, nowadays securities are invariably held in disembodied form by clearing houses, nominees or custodians. Nobody entering into such an arrangement would suppose that to do so would compromise rights. Yet, these arrangements often give rise to problems when the beneficial owners, an expression used here in a purely colloquial sense, advance claims relating to their shareholding. Recent decisions have increasingly challenged the assumption that only registered shareholders can succeed, particularly when the custodian relationship can be characterised as a trust.

THE BASIC PRINCIPLE: CLAIMS AGAINST THE COMPANY AND DERIVATIVE CLAIMS

The curious meandering of Commonwealth and English authorities does not in truth make a firm bedrock applicable in every situation. The case for recognition of beneficial interests is clearly stronger in some cases than others. It does not therefore follow that beneficial interests must be discarded in every case. It seems that a beneficial owner may bring claims against the Company but may find it difficult to mount a derivative suit. As the editors of Professor Gower's *Modern Company Law*, (4th ed, 653-4) point out there is often a fine line between such cases.

Direct claims

First, take the case of a beneficial owner invoking rights against the Company that arise from his shareholding. The case law begins with the decision of *Bagshaw v Eastern Union Railway Company* (1849) Hare at 114 in which Wigram VC considered that an assignee could bring a claim against the Company to ensure rights conferred by the scrip that had been purchased. The decision was upheld on appeal. Similarly an equitable mortgagee of shares was allowed to enforce rights against the Company by Kindersley in *Binney v Ince Hall Coal and Channel Company* (1866) 35 LJ Ch 363. Accordingly, it seems in the older cases that direct claims could be brought by non-registered investors.

Derivative claims

Next consider derivative corporate claims against third parties brought by beneficial owners of shares. A clear decision in favour of such an outcome was *Great Western Railway Co v Rushout* (1852) 5 De G. & Sm. 290. The case involved a claim against outsiders on behalf of the company by four beneficial owners whose beneficial title was clear and not in doubt. This was therefore a derivative claim. Wigram VC could not see any objection since the trustee was a defendant to the action.

Over a century passed before the matter came up in *Schultz v Reynolds* [1992]-3 CILR 59. The Cayman Court of Appeal came to the conclusion that a beneficial owner could not bring a derivative claim to the conclusion that a beneficial owner could bring no derivative claim. The Court referred to the principle that a company was not obliged to recognise

the existence of trusts over its shareholdings and suggested that a beneficiary could not bring proceedings unless he joined the trustee shareholder.

The matter came up for further consideration in *Svanstrom v Jonasson* [1977] CILR 19. The short question which arose for decision was whether the beneficial holder of the shares whose name did not appear on the companies' register of shareholders, could exercise the right to sue on behalf of the company in a derivative action based on wrongdoer control. The Court of Appeal of the Cayman Islands noted that *Schultz* had not held in terms that a beneficiary could bring a derivative claim by joining the trustee.

The Court declined to follow *Rushout*. Georges JA adopted the reasoning expressed in the 4th edition of Gower's *Modern Company Law* that it should be left to investors to make the appropriate arrangements either as a matter of contract or trust. Nothing should, so he thought, weaken the fundamental principle of non-recognition by the company of trusts affecting its shares clearly stated by the Court of Appeal in *Re Perkins* [1890] 24 QBD 613 and long embodied in Cl 5 of Table A in England. There is no doubt that *Svanstrom* is the strictest and most difficult of all the authorities.

The judge in the English High Court decision of *Mohammad Jafari-Fini v Skillglass Ltd* [2004] EWHC 3353 (Ch) and [2005] B.C.C. 842 managed to distinguish it. The judge concluded that a beneficial owner of shares should be able to bring a derivative claim against the wrongdoers, if at the same time, he brought a personal claim against his trustee as bringing a derivative claim. On the facts he did not give leave and his decision was upheld by the Court of Appeal without reference to the point. The Judge appears to have been inclined to adopt the reasoning in *Rushout*.

By the 1920s strong but unreasoned *dicta* in

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an Australian case had also firmly shut out the possibility of derivative claims but the rule for derivative actions was reconsidered by the Court of Appeal in Queensland in *Zabusky v Virgtel* [2012] QCA 107. After a detailed review of the earlier cases the Court concluded that:

“A more flexible approach capable of adapting to the justice of particular cases should be adopted. Such a rule would take account of the circumstance that a derivative action is exceptional and should not be allowed to proceed unless the plaintiffs demonstrate in their pleading, perhaps supported by affidavit, that the suit is a proper one. Such a requirement finds expression in a number of the texts and cases. One of the elements of the cause of action is the plaintiff’s standing to sue.”

The Court observed that the register was the starting point to ascertain standing but that “other less complete proofs” would do such as the indisputable proof of the plaintiff’s beneficial title to the shares – *Rushout*. If the evidence sufficiently showed that the claimant was a shareholder then he should be allowed to sue.

In principle, if the registered owner is a trustee, as was the case in *Rushout*, it ought to be possible (at least outside the BVI) to bring a “double derivative” claim following the decision of the Hong Kong Court of Final Appeal in *Waddington v Chan Chu Hoo Thomas* [2008] HKCFA 83 (see *Abouraya v Triangle Metals and Minerals (Hong Kong) Ltd* [2014] EWHC 277). English authority shows that “mixed” multiple derivative claims are possible, in the sense of involving more than one jurisdiction, as in *Waddington* itself, and mixtures of a trust claim against the custodian and corporate claims against the wrongdoers (*Universal Project Management Services v Fort Gillicker* [2013] Ch 551 and *Re Henderson PFI Secondary Fund LLP* [2013] 2 WLR 129). *Svanstrom* may have to be reconsidered in the light of this emerging jurisprudence.

Winding-up petitions

Both *Svanstrom* and *Schultz* were relied upon by Henderson J in the Grand Court of the *Cayman Islands Hamoun v R Ltd* [2009] CILR 124, in which he held that a beneficiary under a bare

trust of shares could not petition for a winding-up on the just and equitable ground. The prospect of such proceedings was alarming, he said, given the special nature and consequences of winding-up petitions. Moreover, it might be said that the statutory right to petition under s 124 Insolvency Act 1985 or s 94(3) Cayman Companies Law is conferred on a contributory normally only in circumstances where that person appears on the register of members. It does not follow that such a petition cannot be brought in the name of a trustee who refuses to act by way of derivative suit.

CUSTODIAN RELATIONSHIPS

Almost invariably the investors in open-ended investment funds or, more popularly, hedge funds are themselves professionals and hold their interests not as registered shareholders but indirectly through custodians, typically financial institutions. The arrangements are designed to give comfort to investors that investments are held by independent parties. Custodians tend to have their own standard form agreements and the arrangements vary considerably.

Most custodians will not bring legal action themselves and many will not lend their name for that purpose. Some custodians will not transfer investments back to the customer as there is no provision for them to do so in the absence of a sale or realisation. Others allow the investor a relatively free hand and amount to little more than bare trusts. When these agreements were originally concluded few people addressed their minds to the importance of retaining control of investments in more litigious circumstances such as those which followed the financial crisis.

Enforceability of side letters

In this climate it is vital to know whether the investor is a creditor for his redemption rights or a shareholder. Many investors relied on side agreements in which they secured preferential rights of redemption but only rarely were those side letters signed by the custodians. In other cases, investment managers have agreed restructuring proposals with investors only to find that they have not signed up the custodians and the investors have had second thoughts.

For example, in *Medley Opportunity Fund v Fintan Master Fund Ltd* [2012] 1 CILR 360

the Defendant sought to rely on the terms of a side letter that it had agreed with the managers of the Fund in respect of its redemption rights with respect to the investment it had made. It was not, however, the registered shareholder but held its interest through a nominee. Like many investors it assumed that as the party with the real economic interest it was able to deal in a binding manner with the investment manager. Not so. Quinn J relying on *Svanstrom* held that the investor could not enforce the side letter. A subsequent decision by Quinn J in *Lansdowne v Matorador* [2012] 2 CILR 81 was to broadly similar effect.

These decisions were distinguished by Jones J in the unreported Cayman Islands Grand Court decision of *Swiss-Asia Ghengis Hedge Fund v Maoming Fund* (24 July 2013). There the Defendant Fund had dealt with Swiss Asia in full knowledge of the custodial arrangement. After a redemption request was submitted by the custodian, the Defendant negotiated a side letter agreement with Swiss-Asia agreeing to cancel the redemption request in return for periodic payments. The custodian was not a party to these discussions. The Fund sought to resile from the letter agreement. The Judge held that Swiss-Asia had apparent authority of the custodian to conclude the letter agreement and that there was a mutual understanding that Swiss-Asia had authority to act.

In the recent decision of the Cayman Islands Court of Appeal *Re Lancelot Investors Fund, LLP; KBC Investments Ltd v Varga* 27 April 2015 the Court of Appeal rejected an argument that the investment manager of the Fund had actual or apparent authority to enter into side letter agreements with investors to vary the terms of redemption. Under the Articles of the fund that power had been vested in the directors and there had not been any sufficient holding out of the investment manager by the directors to justify clothing him with ostensible authority to vary redemption rights. The Court of Appeal also dismissed an argument that, even if he had no right to vary the redemption rights, the investment manager had ostensible authority of the directors to convey to KBC that he was transmitting an offer to enter into an agreement.

Swiss-Asia and *Lancelot* are useful reminders that the question whether a side letter concluded by an investor is binding is a matter of contract

Biog box

Thomas Lowe QC is a barrister practising from Wilberforce Chambers in England and independently in the Cayman Islands. Email: tlowe@wilberforce-cay.com

and should not depend on decisions such as *Svanstrom* or provisions which entitle the Fund not to recognise trusts over shares. The right to rely on such side agreements has nothing to do with the exceptional considerations applicable to derivative actions. More probably, the ability to bind depends on questions of authority. For example, a side letter agreement concluded by the investor without first obtaining authority can be ratified by the custodian. If as in *Swiss-Asia*, the parties act on the assumption that it will be binding as between the registered shareholder and the Fund that may be good enough.

Redemption creditors and proofs of debt

Re Lancelot is also a good example of the benefit of being able to characterise the custodian agreement as a bare trust. Again, the investor claiming in respect of its rights was not the registered shareholder.

KBC's investments in the Lancelot Fund were held by Fortis, which was in run-off by the time of the proceedings after the collapse of ABN Amro its parent company. Lancelot collapsed in the wake of the little-known but massive Petters fraud. Fortis, which was the registered shareholder, had submitted a redemption request to the Lancelot Fund and after liquidation filed a proof of debt. When the liquidator rejected the proof, KBC and not Fortis appealed. The Judge held that KBC had no standing and that only Fortis could have appealed.

Martin JA held that when the Company went into liquidation Fortis became a creditor in respect of its unpaid redemption. Its right to receive a dividend was no longer a matter tied to its registered shareholding but was a freely assignable chose in action. It was clear from a number of the provisions of KBC's custodian agreement with Fortis that it was in reality in the position of a bare trustee.

Whilst Fortis remained a shareholder the Fund did not need to recognise KBC's interest. The Fund would not therefore have honoured a redemption request from KBC. However, as soon as Fortis' status changed to that of creditor, there was no reason why KBC could not insist on being treated as equitable assignee of the debt, even before the custodian agreement was terminated. In principle, he held that KBC was

entitled to maintain the proof of debt appeal.

The significance of this aspect of *Lancelot* for all cases in which a custodian agreement can be characterised as giving rise to a bare trust is that the beneficial holders can step forward themselves as redemption creditors without too much formality to enforce their rights in liquidations. It is also some encouragement for the view that custodian relationships may be characterised as a trust.

Clearing house relationships

In the unreported decisions of *Re Alibaba.Com Ltd* (20 April 2012) and *Little Sheep Group Ltd* unrep 20 January 2012 the Grand Court of the Cayman Islands had to deal with a difficult question which arises from the fact that a substantial proportion of shares listed in Hong Kong are held by a clearing company, HKSCC Nominees Ltd, as part of Hong Kong's Central Clearing and Settlement System depository. HKSCC acts only for market participants, financial institutions, who hold their interest at HKSCC on behalf of their clients. The ultimate beneficiary holds through two nominees.

Both cases concerned schemes of arrangement. The issue in each was how to operate the headcount test in circumstances where HKSCC acted as a nominee for numerous interests each of whom would be entitled to vote on the scheme of arrangement that was being proposed. In England the traditional solution, adopted in Hong Kong, was to allow HKSCC to vote its shares according to the instructions received from market participants but allow it only a split single yes and single no vote for the purposes of the headcount test.

In *Little Sheep Group Ltd*, Jones J had held that in the Cayman Islands it was possible to look through the register and allow a headcount equal to the number of instructions received from market participants. In *Alibaba.Com*, Cresswell concluded that Jones J had been wrong and preferred the approach of the Courts in England and Hong Kong. The Courts have not fashioned any more inventive solution for the problem presented by the form of Hong Kong share ownership.

The HKSCC relationship also gives rise to difficulties when the owner of listed shares wants to bring legal proceedings. Hong Kong listed companies are frequently incorporated

in offshore jurisdictions such as the Cayman Islands or the BVI. Beneficial owners are likely to find it difficult to bring derivative actions against directors or third parties or to invoke the jurisdiction of the Court to hear just and equitable petitions. They will be met by arguments based on *Svanstrom* and *Hanoun*. Perhaps it will be possible to rely on double derivative claims in the future.

CONCLUSION

As the Court in *Lancelot* observed "there is no doubt that in ordinary circumstances the rights attaching to shares may only be pursued by the registered shareholder". That rule may be reinforced by statute as it is in the case of contributory petitions. However, in other contexts the highpoint of the rule that an investor cannot vindicate rights as shareholder is the decisions in *Svanstrom*. The rule frequently operates harshly, as the Court of Appeal in *Svanstrom* expressly recognised.

There has in truth never been a rule of this kind where the shareholder is seeking to enforce shareholder rights against the Company. The more difficult case is where the beneficial owner is bringing a derivative claim against a third party. Such claims are exceptional and are controlled by the Courts. As the cases show, the Courts are moving towards recognition of exceptional cases to the general rule in derivative actions.

It is, however, difficult to see why this rule has any application in the various claims against companies concerned with redemption requests. Not only are these cases covered by the reasoning in cases such as *Bagshaw v Eastern Union Railway* but they plainly turn on questions of authority as highlighted by the recent Court of Appeal decision in *Lancelot*. ■

Further Reading:

- Cayman Islands' mutual funds: striking a balance between investor protection and fund stability [2010] 7 JIBFL 416.
- UCITS and the Madoff scandal: liability of depository banks? [2009] 6 JIBFL 338.
- LexisNexis Financial Services blog: reclaiming funds following fraud.