



**IN THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION**

CAUSE NO: FSD 3 OF 2019 (IKJ)

**IN THE MATTER OF SECTION 131 OF THE COMPANIES ACT (2018 REVISION)
AND
IN THE MATTER OF ASCOT FUND LTD. (IN OFFICIAL LIQUIDATION)**

Appearances: **Mr Tom Lowe QC of counsel and Mr Marc Kish and Ms Gemma Lardner of Ogier for hfc Limited (the “Representative Party”/ “Contrarian”)**

Mr Tom Smith QC of counsel and Mr James Eldridge and Mr Luke Armitage of Maples and Calder for the Joint Official Liquidators (the “JOLs”) of Ascot Fund Ltd. (the “Fund”)

Before: **The Hon. Justice Kawaley**

Heard: **25-26 November 2020**

**Draft Judgment
Circulated:** **7 January 2021**

Judgment Delivered: **11 January 2021**

HEADNOTE

Solvent liquidation of fund company-distribution rights of members-contractual right to pari passu distribution before and after commencement of winding-up-distribution of proceeds of pre-liquidation settlement of New York proceedings in a manner preferential to members with small shareholdings- whether adjustment required to post-liquidation distributions to take into account benefits conferred on small shareholders by settlement distribution- whether distribution of settlement proceeds constituted unlawful return of capital by the company- liability of members in restitution for receipt of unlawful distributions

JUDGMENT



Introductory

1. By a Summons dated July 1, 2020, the JOLs sought directions as to whether they should receive this Court's sanction for making distributions to the Fund's members/shareholders without making adjustments for monies received by shareholders who participated in the New York Supreme Court proceedings *The People of the State of New York-v-J. Ezra Merkin, Gabriel Capital Corporation & Others* (Index No.450879/2009) (the "New York Proceedings" and the "the Merkin Settlement", respectively) commenced by the Attorney General for the State of New York in 2009 (the "NYAG"/the "NYAG Action").
2. The procedural directions for this application were sensibly agreed and embodied in a Consent Order dated July 1, 2020 which accompanied the Summons. It provided for the question of whether an adjustment was required to take into account the impact of the Merkin Settlement (the "Merkin Adjustment Issue") to be determined on the basis of an agreed statement of facts ("Agreed Statement of Facts") with counsel for the Representative Party arguing that an adjustment was required and counsel for the JOLs contending that no adjustment was required. The capped first instance costs of the Representative Party were directed to be treated as an expense of the liquidation.
3. In the result the Merkin Adjustment Issue was argued with considerable economy and clarity for which I am indebted to counsel. The critical issues were distilled into the following points:
 - (a) whether the monies received by the Fund's members/shareholders as proceeds of the Merkin Settlement (the "Merkin Payment") constitute an unlawful distribution to members;
 - (b) whether those members/shareholders who benefitted from the Merkin Payment were liable to restore any unlawful benefit received;
 - (c) whether (assuming the first and second questions were answered in the affirmative) the relevant recipients would in any event have a change of position defence to any restitutionary claim the JOLs might bring.

4. It was essentially agreed by the end of the hearing that only the first two issues really required formal adjudication.



Findings: salient features of the Agreed Statement of Facts

Overview

5. The Agreed Statement of Facts listed 56 “relevant events” in a 17 page document and exhibited the First Affidavit of Michael Penner, a partner of Deloitte and Touche Cayman Islands, one of the JOLs, as well as various other documents. The Exhibit, which ran to 1128 pages, exhibited all of the documents agreed to be relevant to the disputed issues.
6. The Fund was incorporated on February 7, 1992 to act as a feeder fund into a Delaware limited partnership, Ascot Partners LP (“Ascot Partners”) and engaged J Ezra Merkin’s Gabriel Capital Corporation (“GCC”) as the Fund’s Investment Manager. In November 2002, Mr Merkin (“Merkin”) advised investors that effective December 31, 2002, the Fund would become a limited partner of Ascot Partners and that all the Fund’s assets would be invested with the partnership. From January, 2003, Ascot Partners invested substantially all of its assets with Bernard L Madoff Investment Securities LLC (“BLMIS”).
7. On December 11, 2008, it was publicly announced that BLMIS was a Ponzi Scheme (“Madoff Fraud”). On December 15, 2008, the Fund suspended the determination of its net asset value. At that point, there were no unpaid redemption creditors. Three days later, Merkin as general partner of Ascot Partners notified the Fund that the partnership would be dissolved and that all withdrawals were suspended. In January 2009 the NYAG commenced an investigation into, *inter alia*, Merkin and GCC and their investments with BLMIS.
8. On April 6, 2009, the NYAG commenced the NYAG Action in the Supreme Court of the State of New York (the “New York Court”) in relation to Merkin and GCC’s investments with BLMIS on behalf of the Fund and Ascot Partners (the “Ascot Parties”) and Ariel Fund Limited (“Ariel”) and Gabriel Capital, LP (“Gabriel”). Irving H. Picard, the Trustee of BLMIS and Bernard L Madoff’s bankruptcy estate sued Merkin, GCC, Ascot Partners, Ariel and Gabriel seeking the return of, *inter alia*, \$461 million from Ascot Partners. On May 28, 2009, the Ascot Parties were joined as “Relief Defendants” to the NYAG Action.
9. On September 16, 2010, Bart M Schwartz as Receiver of, *inter alia*, Ariel and Gabriel commenced a civil action against Merkin and GCC (“Schwartz Action”). Earlier that year,



initial settlement negotiations took place between the NYAG, Merkin, the Ascot Parties and Schwartz. The Fund never commenced a freestanding action against Merkin. However, the Ascot Parties did enter into a confidentiality agreement pertaining to sharing information about a potential settlement on January 5, 2012 (“Confidentiality Agreement”). On June 13, 2012 the parties to the NYAG action concluded the Merkin Settlement Agreement. However, the BLMIS Trustee commenced proceedings designed to restrain the consummation of that agreement on August 1, 2012.

10. In June 2013, the Ascot Partners Receiver sent the “Merkin Settlement Package” to the Fund’s investors, inviting their participation. In the weeks which followed, as explained in the First Affidavit of Michael Penner dated January 25, 2019 (at paragraph 25), the majority of the Fund’s shareholders participated in the Merkin Settlement and received funds according to the prescribed basis for distribution. This was based on investors’ net invested capital (“NIC”) rather than net asset value (“NAV”) and, most significantly, entailed caps which favoured small investors. Under the formula, 42% was allocated to losses under \$5 million while only 2.5% was allocated to losses over \$5 million.
11. It was only after these distributions had been made (or agreed to be made), on September 21, 2013, that the Representative Party, owned by Contrarian Funds LLC, became a registered shareholder of the Fund. Its shares were purchased in two tranches on July 24, 2017 and August 31, 2017.
12. On June 12, 2018, the BLMIS Action was settled and Ascot Partners subsequently received just over \$140 million from the Trustee and from the sale of certain claims. The Fund adopted the position that any monies due to its investors should be distributed by the Fund according to its constitution. On August 25, 2018, Contrarian’s then attorneys argued that the Merkin Settlement payments were effectively dividends distributed by the Fund otherwise than on the usual *pro rata* basis. Accordingly, a “Merkin Payment Adjustment” was required.
13. This prompted the sole voting shareholder of the Fund, accepting the Board of Directors’ recommendation, to resolve on October 24, 2018 to appoint Messrs Michael Penner and Timothy Derksen of Deloitte and Touche Cayman Islands as joint voluntary liquidators of the Fund. On December 13, 2018, Contrarian commenced proceedings against the Fund and Ascot Partners seeking to place the Fund’s New York assets under the control of a receiver. On January 16, 2019, the joint voluntary liquidators applied to this Court for the voluntary liquidation to be continued under the supervision of the Court. That application was granted on February 14, 2019 when the JOLs were appointed as joint official liquidators.



14. On August 12, 2019, the Fund’s liquidation herein was recognised by the United States Bankruptcy Court under Chapter 15 of the US Bankruptcy Code triggering an automatic stay of the Proceedings commenced in New York by Contrarian. On September 30, 2019, the JOLs notified the Fund’s shareholders that the Merkin Adjustment Issue would be placed before this Court.

The facts emphasised by Contrarian

15. The Representative Party’s central thesis was most clearly and crisply stated in its Reply Skeleton:

“3 Contrarian’s case is simply that ‘the substance’ of the Merkin Payments was that they were the proceeds of a chose in action belonging to the Ascot Fund that was monetised and paid to investors. Payments can in law constitute a dividend if they represent such a distribution even if not paid directly.”

16. Mr Lowe QC in oral argument emphasised, *inter alia*, the following factual matters:

- (a) the NYAG Action was based on the basic allegation that Merkin had falsely represented that he was managing assets when he was not. It followed that the Fund (as a limited partner of Ascot Partners) had a claim for the management fees it had paid;
- (b) the distribution scheme originated with the NYAG, not the Fund (or Ascot Partners);
- (c) although the Fund’s directors became involved in the settlement process at a late stage, all of the Fund’s claims were released. No evidence had been produced in relation to a Board meeting approving this decision nor had any legal advice been disclosed.

The facts emphasised by the JOLs

17. The JOLs’ central thesis is most clearly and concisely captured in the following submissions in their Skeleton Argument:



“3.1 Firstly, and most fundamentally, the Merkin Payments were not a distribution of Ascot Fund's assets. These moneys were not and could never have been assets which Ascot Fund owned, controlled, or even had visibility on. They were also not the ‘price paid’ for any releases given by Ascot Fund (which were in any case of little or no real value). They were certainly not a ‘dressed up’ or ‘disguised’ dividend of the kind addressed in the Aveling Barford line of authorities. The Merkin Settlement was exactly what it claimed to be: a sui generis compensation scheme, negotiated by the NYAG, and approved by the New York Supreme Court, for the benefit of the certain ultimate investors of Ascot Fund (and other similarly situated investors in other funds).”

18. In oral argument, Mr Smith QC contended that the crucial factual considerations included the following:
- (a) the Merkin Settlement payments were made in response to the NYAG’s claim;
 - (b) the claims asserted by the NYAG were his claims and so the recoveries made were not assets of the Funds;
 - (c) the releases given by the Funds were merely ancillary to the Merkin Settlement. It was unclear how the Fund as a limited partner of Ascot Partners would have had standing to sue Merkin.

Summary of main factual controversies

19. It is readily apparent that the fundamental disputes centre on mixed questions of fact and law revolving around how the NYAG Action, the Merkin Settlement and the payments made to the Fund’s shareholders pursuant to the Settlement should be characterised.
20. My initial response to the materials placed before the Court was that Contrarian’s position was consistent with a broad-brush commercial view. The Fund’s shareholders had suffered investment losses caused in part by Merkin. The Merkin Settlement provided compensation for such losses and the Fund released the paying parties in respect of any future claims. Administratively, the monies were funnelled directly to the Fund’s shareholders but in substance the monies were distributions made by the Fund to its



shareholders and should according to the relationship between them have been distributed on a *pro rata* basis.

21. In contrast, the JOLs' position appeared more consistent with a rigorous legal analysis combined with a more nuanced interpretation of the facts. Despite the fact that on superficial analysis the Fund released its claims in return for the settlement proceeds being paid directly to its shareholders, it was argued that those funds could not properly be viewed as representing assets of the Fund which were even notionally a distribution to its shareholders.
22. How the Merkin Settlement should be characterised is in my judgment the most pivotal threshold question which arises on the present application. If it culminated in what was essentially a distribution by the Fund on a basis inconsistent with the Fund's constitutional distribution principles, the need to consider what adjustments can be made is properly engaged. If it was not a distribution by the Fund at all, no question of any need for the Merkin Adjustment is seriously raised.

Findings: did the payment of the Merkin Settlement proceeds to the Fund's shareholders constitute a distribution of the Fund's assets?

The NYAG's Summons

23. The first of two key documents relevant to the characterisation of the claims which generated the Merkin Settlement payments is the NYAG's Summons, signed by then Attorney General Andrew Cuomo on April 9, 2009, and the supporting Complaint. The key premise of the Summons was set out at the outset in the following terms:

“2. Merkin’s Ascot funds, Ascot Partners, L.P., and Ascot Fund Limited (together ‘Ascot’), were formed in 1992 to be, and always were, ‘feeder’ funds that entrusted Bernard L. Madoff with virtually all of their assets. Madoff then stole, dissipated or lost those funds in a massive Ponzi scheme. All the while Merkin deceived Ascot investors into believing Merkin, not a third party, was actively managing their investments. In fact, Merkin did little work for Ascot other than routine bookkeeping and engaging in occasional telephone conversations with Madoff. In the words of one investor who, like most, learned only in December 2008 that Madoff, not Merkin, managed Ascot’s assets, Merkin was just a ‘glorified mailbox.’”



24. The standing of the NYAG to bring the claim was pleaded as follows:

“JURISDICTION AND VENUE

7. The Attorney General has an interest in the economic health and well-being of investors who reside or transact business within the State of New York. In addition, the Attorney General has an interest in the financial well-being of non-profit organizations that operate within the State of New York. The Attorney General is also responsible for overseeing the activities of New York not-for-profit corporations and the conduct of their officers and directors. The State of New York, moreover, has an interest in upholding the rule of law generally. Defendants’ conduct has injured these interests.

8. The State of New York brings this action in its sovereign and quasi-sovereign capacities as parens patriae; and pursuant to Executive Law §§ 63(1) and 63(12), General Business Law §§ 352 et seq. (the “Martin Act”), and Not-for-Profit Corporation Law (“N-PCL”) §§ 112, 717, and 720.

9. Pursuant to Executive Law 63(12), the Attorney General is authorized to bring an action for restitution, damages, and other relief in connection with repeated fraudulent or illegal acts in the carrying on of any business.

10. Pursuant to the Martin Act, the Attorney General is authorized to bring an action for restitution of money obtained as the result of any fraudulent practices in connection with the sale of securities.

11. Pursuant to N-PCL § 720, the Attorney General is authorized to bring an action to require the directors and officers of a New York not-for-profit corporation to account for the management and disposition of corporate assets and for transfers, loss, or waste of corporate assets in violation of their duties and to recover all resulting damages from officers and directors.

12. The Attorney General also has common law parens patriae authority to protect the public interest.

13. The State seeks restitution, damages, costs, and equitable relief with respect to Defendants’ fraudulent and otherwise unlawful conduct.

14. Defendants’ actions originated from New York, New York, where Defendants reside and/or conduct business. Moreover, numerous New York investors, as well as the interests of the State of New York, were harmed by Defendants’ conduct.”[Emphasis added]



25. These averments were consistent with the fact that sole plaintiff was styled in the Summons as follows: “*THE PEOPLE OF THE STATE OF NEW YORK* By *ANDREW M. CUOMO ATTORNEY GENERAL OF THE STATE OF NEW YORK*”. They clearly signify that the NYAG Action was brought in the public interest for the benefit of investors located in or conducting business in New York State who were victims of the allegedly fraudulent conduct of Merkin in relation to investments he had purportedly managed, but which had in reality been managed by Bernard L Madoff. In my judgment the jurisdictional basis for the NYAG Action is far more informative for present purposes than the nature of the claims subsequently set out in the Complaint (in unsurprisingly summary legal terms). The crucial question is not whether the Fund could potentially have asserted equivalent or similar claims. Rather, the crucial question is whether the fruits of the compromise of the claims which were actually advanced by the NYAG should be characterised as monies received by the Fund and distributed by it to its shareholders. The terms of the Complaint provide powerful support for the JOLs’ contention that the claims were quintessentially public interest claims for the benefit of private investors rather than public or private claims brought on behalf of affected third parties such as the Fund and/or its underlying shareholder investors.
26. Mr Lowe QC relied heavily on the fact that the Fund and Ascot Partners were joined as “Relief Defendants” to the NYAG Action at an early stage (May 28, 2009) in aid of his client’s position. That can indeed potentially be viewed as indicating that the NYAG was bringing the claims in the NYAG Action on behalf of the Fund. However, this would not be a fair reading of the Complaint in light of clear terms of the Jurisdiction and Venue section, the averments of which are not contradicted by any extraneous evidence. The correct analysis must be, as Mr Smith QC submitted, that the claims were brought by the NYAG in the public interest for the express purpose of compensating victims of Merkin’s alleged misconduct. In other words, the claims were brought for the benefit of persons and entities who had invested through the Fund and Ascot Partners with Messrs Merkin and Madoff.
27. This framing of the NYAG’s Complaint is fortified by a review of the other most important document in this case, the Merkin Settlement itself.

The Merkin Settlement

28. The June 13, 2012 Settlement Agreement contains a few provisions which are of particular relevance to the characterisation of the claims which were compromised in return for the payments the Fund’s shareholders ultimately received. The following are worthy of mention:



- (a) the recitals make it clear that the NYAG Action was commenced based on an investigation carried by the NYAG;
- (b) Section 1(H) defines “investor” as including persons who invested in, *inter alia*, the Fund, not the Fund itself;
- (c) Section II(B) provides for the “Settlement Amount” to be paid by Merkin to the NYAG;
- (d) Section III(A) provides that, *inter alia*, the Fund:

“in consideration of this Settlement Agreement, shall release and forever discharge Defendants... from each and every action, cause of action, suit, debt, claim for money, rescission, restitution, covenant, agreement, promise, claim, and demand, of any nature whatsoever, in any way arising out of, relating to or based upon: (i) the disclosures made by Defendants concerning the Funds and the Funds’ investments, including, without limitation, in the Funds’ offering memoranda, limited partnership agreements or other written or oral communications; (ii) the Funds’ investments with Madoff; (iii) Defendants’ management of or duties to the Funds or any Investor; and (iv) any Investor’s or former investor’s investment in the Funds, including, without limitation, any alleged failure to disclose or failure to conduct adequate due diligence; whether known or unknown, in law or equity, whether statutory or common law, whether federal, state, local, foreign or otherwise, including, but not limited to, any claims relating to, or arising out of any aspect of the Funds, the investments of the Funds, the Funds’ investment with Madoff, any Investor’s investment in any of the Funds, the Funds’ offering memoranda or limited partnership agreements, or any other claim that was or could have been brought in the Action...” [Emphasis added];

- (e) Section IV prescribes a separate procedure for Investor Releases. As regards the Fund, the Ascot Partners Receiver was required to send Investors a Notice approved by the NYAG setting out the amount of each Investor’s loss and potential settlement amount and inviting them to participate by accepting the



relevant amount and executing a release, thus becoming “Participating Investors”. (Nothing in the prescribed form of Notice which was sent by the Ascot Partners Receiver implied that the settlement monies belonged to the Fund. Instead, it described the NYAG as having agreed to make most of his recoveries available for distribution to Participating Investors);

- (f) Section V provides for the (Ascot) Participating Investors to be paid by the Ascot Partners Receiver from an Escrow Fund maintained by the Receiver and Section V (E) expressly provides: “*Under no circumstances shall any funds in the Ascot Defense Fund, the Distribution Escrow or the Investor Escrow be deemed to be the property of the Funds*”.

29. The strongest factor which potentially supported Contrarian’s position was rightly emphasised by Mr Lowe QC. The Fund clearly released the Merkin parties from all claims in any way related to their management of the Fund, including claims which could have been brought in the NYAG action (or otherwise) but had not been brought. On one view, this strongly implied that the Fund must have been, in terms of commercial reality, a beneficiary of the Settlement Agreement. Mr Smith QC merely parried this point by noting that the Fund’s release was, according to the terms of the Settlement Agreement itself, granted “*in consideration of this Settlement Agreement*”. Mr Lowe QC also fairly complained that the Fund had produced no evidence (such as contemporaneous Board minutes, resolutions or legal advice) explaining on what basis the directors decided to participate in the Settlement Agreement and release all of the Fund’s claims against Merkin.
30. Direct evidence of the Fund’s directors’ decision-making processes would have been helpful but is not indispensable to the task of characterising the role the Fund played in relation to the NYAG Action and the Merkin Settlement. In my judgment the only inference which can fairly be drawn from the material placed before the Court is that the Fund, at a minimum, considered that the benefits the Settlement Agreement yielded for its shareholders was sufficiently substantial to justify the Fund abandoning any right it had to pursue independent action. There is no basis for characterising the Settlement Agreement, construed together with the NYAG Action, as evidencing a compromise which culminated in settlement monies being received and/or distributed by or on behalf of the Fund. Superficial appearances to the contrary notwithstanding, it does not follow from the bare fact that the Fund gave the releases which it did that the settlement funds were in substance received by the Fund in return for its abandoning its claims.



31. As Mr Smith QC pointed out, the Fund had never even commenced any proceedings against Merkin or the Merkin Parties. There is no evidence that such proceedings were even contemplated, let alone threatened. The only claims which were actually formally asserted and substantively compromised were asserted by the NYAG. Finally, and most decisively, Section V (E) expressly provided that none of the Escrow monies constituted assets of the Fund. Further, and looking at the Settlement Agreement more broadly, there is commercial rationality to the Fund releasing any hypothetical claims it might have against the Merkin Parties in return for the settlement monies recovered by the NYAG being funnelled directly to the Fund's shareholders. The following inferences must be drawn from the Agreed Facts:

- (a) the NYAG acted with remarkable speed and efficacy by instituting an investigation within weeks of the public disclosure of the Madoff Fraud into the activities of the Merkin Parties and commencing proceedings roughly three months later in April 2009;
- (b) the NYAG's public interest claims appear to have had greater strength than private law claims would have. Settlement discussions started in early 2010, and the Settlement Agreement was consummated on June 13, 2012. NYAG Eric Schneiderman in a June, 2013 letter to investors described the settlement of the NYAG's litigation as "*resulting in an unprecedented recovery of \$410 million*";
- (c) the Fund had expended no or no significant resources towards obtaining this boon for its shareholders;
- (d) the Fund had not identified any private law claims of its own worth pursuing;
- (e) it was in these circumstances on the face of it (and in the absence of evidence to the contrary) commercially rational for the Merkin Parties to seek and the Fund to give releases to eliminate the hypothetical possibility of future private litigation covering overlapping factual ground.



Summary of findings

32. The characterisation issue was not straightforward to resolve for two main reasons. Firstly, the Settlement Agreement arose out of what was for me an unfamiliar and unusual factual matrix. In the absence of expert evidence on New York law, it was not easy to reach a nuanced view of the precise nature or character of the NYAG's claims. I ultimately am satisfied that what fundamentally matters is that they were his claims and not the Fund's claims. I reach this conclusion primarily because there is no suggestion that any other claims had been asserted by the Fund in its own right. Further and in any event, it is clear on the face of the Complaint and consistent with common sense that the NYAG primarily commenced the proceedings in the public interest.
33. Secondly, because the Fund is now in official liquidation, it was initially difficult to avoid viewing what happened through the lens of what ought to have happened if the Fund had been in liquidation when the Merkin Settlement was consummated. Mr Smith QC accepted that a different analysis would probably have applied. He reminded the Court that the settlement was consummated 8 years ago under New York law. I ultimately agree that re-characterising the settlement transaction 8 years later under Cayman Islands law is not a conclusion this Court should lightly reach.
34. For the above reasons, I ultimately find that the settlement monies which the Fund's shareholders received, and which were derived from the Merkin Settlement, did not constitute assets belonging to the Fund. The relevant funds were neither actually nor constructively distributed by or on behalf of the Fund. The settlement proceeds were recovered by the NYAG through a compromise of public interest litigation conducted for the primary purpose of directly compensating the underlying investors in the Fund and other entities. It was expressly agreed (Settlement Agreement, Section V (E)) that the settlement proceeds in the escrow account from which the payments were made should "[u]nder no circumstances...be deemed to be the assets of the Fund..."

Findings: was the distribution of the settlement proceeds an unlawful distribution by the Fund to its shareholders?

35. It is common ground that the distribution basis under the Merkin Settlement Agreement was inconsistent with that prescribed by the Fund's constitution in that it departed from both the NAV and *pari passu* principles and preferred smaller investors over larger ones.



36. Having resolved the threshold question of whether any distribution of the Fund’s assets occurred in favour of the JOLs, it is not necessary to formally decide whether or not any legal basis for recovering any putative overpayments exists. The legal principles governing claims for recovering unlawful distributions of capital and/or unjust enrichment are far from straightforward and are largely shaped by the factual matrix out of which the putative claim arises. Any attempt to analyse the relevant principles on the basis of a factual hypothesis which I have rejected would in my judgment be an almost meaningless forensic exercise, as intellectually engaging as it would undoubtedly be.
37. On the other hand, it is important to record the legal principles which have guided my approach to the threshold question of whether any distribution of assets belonging to the Fund in fact occurred. Those principles were illuminated by counsel when exploring the question of whether the ‘overpayments’ some shareholders received could potentially be impugned at the suit of the JOLs.
38. In Contrarian’s Skeleton Argument, it was submitted (based on its contentions as to how the transactions should be construed):

“22. Accordingly, it is submitted that the distribution of the proceeds of the Ascot Fund’s assets (i.e. the chose in action against Merkin and GCC), howsoever labelled or dressed up, involved in law a return of capital to investors (see Aveling Barford [1989] BCLC 626; Progress Property v Moore at [20]-[22], [30] [50]). The fact that payment is made through the instrumentality of a third party is immaterial (see Re Walters Deed of Guarantee [1933] Ch 321 and British & Commonwealth v Barclays Bank [1996] 1 WLR 1).”

39. In the JOLs’ Skeleton (at paragraph 19), reliance was placed in particular on the UK Supreme Court decision in *Progress Property Co Ltd v Moore and another* [2011] 1 WLR 1 and the following *dicta* of Lord Mance:

“42. On this basis, the question now before the Court is one of characterisation. Did the agreement between PPC and Moorgarth involve a distribution of PPC’s capital to TUK through Moorgarth? This is a question of substance (or of examining the ‘essence’ of the agreement, as the New Zealand Court of Appeal put it in Jenkins v Harbour View Courts Ltd [1966] 1 NZLR 1). It is not necessarily answered by the way in which the parties have expressed themselves. Like Lord



Walker, I would not go so far as Mr McGhee QC for Moorgarth in his submission that the ultimate test is always one of the directors' (subjective) motives in effecting the transaction. The courts will not second-guess companies with regard to the appropriateness or wisdom of the terms of any transaction: see e.g. In re Halt Garage (1964) Ltd [1982] 3 All ER 1016. But there may come a point at which, looking at all the relevant factors, an agreement cannot be regarded as involving in substance anything other than a return or distribution of capital, whatever the label attached to it by its parties. I do not regard Aveling Barford Ltd v Perion Ltd [1989] BCLC 626 as inconsistent with this. The facts in that case made it possible to speak of knowledge and intention to sell at an undervalue, but that does not mean that such knowledge or intention are always necessary factors. In the present case, it is however unnecessary in my view to go further into such areas.”¹

40. In the present case, Mr Smith QC submitted that the directors' intentions were to some extent relevant alongside an objective analysis. Mr Lowe QC contended that the subjective intentions of the directors were irrelevant. This is clearly sometimes the case. As Lord Walker opined in the *Progress Property Co Ltd* case:

“28. Sometimes, their states of mind are totally irrelevant. A distribution described as a dividend but actually paid out of capital is unlawful, however technical the error and however well-meaning the directors who paid it...the same is true of a payment which on analysis is the equivalent of a dividend...”

29. The subjective intentions of the participants are however sometimes relevant, and a distribution dressed up as an arm's length transaction is a paradigm example...”

41. I find that since no direct evidence has been adduced as to what the directors' subjective intentions were in the present case and there is no question of the relevant transaction being disguised, the predominant analysis must be an objective one. I am also satisfied that the same analytical approach is justified, for present purposes, irrespective of whether one is analysing a potentially unlawful distribution of capital or an unjust enrichment claim. The same threshold question arises in both legal contexts: does the Fund have legal standing to seek the recovery of payments which it ought not to have made? In each case the relevant claim is premised upon a legally impermissible diminution of the claimant's
- 42.

¹ The JOLs' Skeleton omitted the first two sentences of paragraph 42 which is reproduced in full above.



assets or, more broadly, some prejudice to the claimant's financial position which gives rise to an entitlement to compensation.

43. It is true that unjust enrichment is a flexible enough remedy to permit a claimant to recover assets paid to a recipient by a third party, but this presupposes that the target assets at some point belonged to the claimant. The claimant must have been prejudiced by the transaction which resulted in the defendant's allegedly unjust enrichment. For instance, Goff & Jones, *'The Law of Unjust Enrichment'*, 9th edition states (at paragraph 8-104):

"There are many common law cases where D has immediately received a benefit from X, but has more remotely received the benefit from C, and C has been given a personal claim against D which can be explained as responding to C's lack of consent or authority. Consistently with the general character of personal claims in unjust enrichment, D's prima facie liability is strict-it does not depend on C proving fault on D's part-and is measured by the value received." [Emphasis added]

44. My findings that the Fund did not directly or indirectly distribute its assets through its participation in the Settlement Agreement is based on an analysis of the transaction applying the substantive legal analysis which was it was effectively common ground should be applied.

Findings: are the preferred shareholders liable to repay the sums they have improperly received?

45. In light of my primary finding that no distribution of the Fund's assets occurred through the Merkin Settlement transaction, there is no need to consider whether any liability to repay arises.

Conclusion

46. In summary, the JOLs are entitled to make distributions to the Fund's shareholders without making a Merkin Adjustment to take into account of the fact that the proceeds of the Merkin Settlement received by many of the Fund's shareholders were distributed pursuant to the Merkin Settlement Agreement otherwise than on a *pro rata* basis. I will

hear counsel if required on the terms of the final Order and any other matters arising from the present Judgment.

A handwritten signature in blue ink, appearing to be 'IAN RC KAWALEY', written over a horizontal line.

THE HONOURABLE MR JUSTICE IAN RC KAWALEY
JUDGE OF THE GRAND COURT