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Help is at hand: Options for investors in troubled Cayman joint ventures

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Cayman companies are frequently used for joint ventures between international parties, especially where the ultimate aim is a listing on a major stock exchange such as the NASDAQ or LSE.

However, given the economic climate many companies may now be unable to meet the performance expectations or exit terms that were originally negotiated. As an investor, it is important to understand what options may be available to you for realizing your investment, and any potential liabilities.

In many cases, the terms contained in the original agreements such as the shareholders' agreement or noteholders' agreement and the company's constitutional documents will be the place to start to see if there are any less nuclear options available. However, when all else fails investors may need to consider the termination of the company.

A shareholder may be able to ask the Cayman court to put the company into liquidation on the basis that it is "just and equitable" for it to be wound up.

In this article, therefore, we will examine the liquidation options available to noteholders and shareholders in Cayman companies. We will also examine a recent line of cases in which the Cayman court has allowed the provisional liquidation regime to be used for restructuring purposes. Finally, we will examine potential liabilities, including for directors.

As these companies typically have operations outside the Cayman Islands, remedies may also be available in the place of operation. However, Cayman insolvency processes are often more cost effective and creditor friendly than overseas alternatives, particularly if the alternative is a US Chapter 7 or Chapter 11 bankruptcy process.

Further, fiduciaries appointed over a Cayman company in the Cayman Islands will typically find it easier to have their appointment recognized overseas than those appointed in a different jurisdiction. This is a particularly important consideration if the company has assets or operations in multiple jurisdictions.

AVAILABLE CAYMAN ISLANDS INSOLVENCY PROCESSES

There are three formal insolvency procedures available in the Cayman Islands:

- official or compulsory liquidation. The main bases on which this may be sought are insolvency, or the just and equitable basis, as discussed further below;
- provisional liquidation, which is often used as a restructuring tool; and
- voluntary/solvent liquidation.

Which option will be available in any situation will depend on numerous factors including the company's Articles of Association, the terms of any other documents governing the relationships between the parties (including any shareholders' agreement or noteholders' agreement), whether the investor is a creditor or shareholder of the company, whether it controls the board of directors or has a sufficiently large shareholding to be able to pass an ordinary or special resolution at a shareholder meeting, and whether the company is solvent.

It should come as no surprise that because these issues can be nuanced and are always fact-specific, we recommend that Cayman legal advice be sought at an early stage.

OPTIONS AVAILABLE TO NOTEHOLDERS — OFFICIAL LIQUIDATION ON BASIS OF INSOLVENCY

A noteholder, as a creditor of the company, may be able to ask the Cayman court to put the company into official liquidation on the ground that it is insolvent.

The test for insolvency under Cayman law is a "cash-flow" test (i.e., is the company presently able to pay its debts when due?) as opposed to a "balance-sheet" test (i.e., do the company's assets overall exceed liabilities?).

However, the right of contingent and prospective creditors to make such a request, combined with recent Court of Appeal authority which states that the test is not confined to debts that are immediately due and payable,[1] may open the door to some consideration of insolvency which falls somewhere between the two.

OPTIONS AVAILABLE TO SHAREHOLDERS — OFFICIAL LIQUIDATION ON JUST AND EQUITABLE BASIS

A shareholder may be able to ask the Cayman court to put the company into liquidation on the basis that it is "just and equitable" for it to be wound up.

What is considered "just and equitable" is not a closed book and includes deadlock (where the parties are unable to agree on how the company should be managed), justifiable loss of confidence in management, or where the company is what the cases have called a "quasi-partnership" (in a nutshell, a company where the parties have legitimate expectations as to how it should be run which are not set out in the legal documents. This is usually, but not always, a 50/50 joint venture, like a partnership, between the parties) and the shareholder's legitimate expectations as to how it should be managed have been breached.

On request by a shareholder on this basis, if the Court is satisfied that it is just and equitable for the company to be wound up, then as an alternative to appointing liquidators, the Court may make an order for alternative relief, including a buy-out order (i.e., an order that one shareholder or the company must buy out another shareholder) or an order regulating the conduct of the company's affairs (which could include an order reconstituting the board of directors or amending the Articles of Association).

One important point to note is that under Cayman law, it is lawful for parties to a joint venture to agree not to make such requests to the Cayman courts. Shareholders should therefore check that the Articles of Association do not contain a "non-petition clause" which would prevent a shareholder from making such a request.

In addition, Cayman law contains strict rules about who can make such an application: a shareholder may only petition if it is the registered owner of the shares and was the original owner, or has held them for at least six months, or inherited them upon the death of a former holder.

VOLUNTARY/SOLVENT LIQUIDATION

A company may be placed into voluntary liquidation by special resolution of the shareholders. The threshold for a special resolution is at least a two thirds majority of those voting at a meeting or a unanimous written resolution.

Once such a resolution has been passed, if the directors are willing and able to sign a declaration of solvency (i.e., a declaration that the company will be able to pay its debts in full within 12 months of the liquidator's appointment), the company's affairs can be settled and the company dissolved by the voluntary liquidator (who does not have to be a professional insolvency practitioner) without the need for Court involvement.

If the directors are not able or willing to sign a declaration of solvency, the voluntary liquidator must apply to bring the liquidation under the supervision of the Court, whereupon the court-supervised voluntary liquidator has the powers of official liquidators.

PROVISIONAL LIQUIDATION

After a winding up application has been made to the court, the company may apply without notice to any other party for the appointment of provisional liquidators on the grounds that:

- it is or is likely to become unable to pay its debts; and
- it intends to present a compromise or arrangement to its creditors.[2]

Creditors or shareholders may also apply for the appointment of provisional liquidators. Such application is traditionally aimed at maintaining the status quo pending the appointment of official liquidators (for example, where there is a risk of asset dissipation), but there has been a recent trend towards permitting provisional liquidators (including those appointed on a creditor or contributory's application) to attempt a restructuring, rather than the company being put into official liquidation and eventually dissolved.

> Investors and creditors of Cayman companies do not generally owe fiduciary duties to each other or the company.

In the recent case of Sun Cheong Creative Development Holdings Limited,[3] provisional liquidators were appointed for the purpose of promoting a restructuring. This was notwithstanding that a parallel winding-up petition had been presented in Hong Kong, and the provisional liquidators' appointment would give rise to an automatic stay of proceedings against the company, resulting in the Hong Kong winding-up petition being stayed.

The Chief Justice confirmed that, all other things being equal, where insolvency proceedings have been commenced in more than one jurisdiction, the jurisdiction of incorporation of the entity will typically be more appropriate to assume the role of primary insolvency proceeding. He also confirmed, affirming his earlier explicit statement in *Re KTH Capital Management Limited v China One Financial Limited & Others,*[4] that the Cayman Islands is an advanced and reputable international financial center which frequently deals with international disputes involving Cayman Islands companies and shareholders in and creditors of a Cayman Islands company may have "a reasonable expectation that the courts here are competent and able to resolve any complex dispute that may arise in an efficient and just manner."

He also confirmed that, provided the criteria set out in the Companies Act are met, the Court has a broad and flexible discretion to appoint restructuring provisional liquidators. The factors that the Court may consider in deciding whether to exercise that discretion include:

- the express wishes of creditors;
- whether the restructuring is likely to be more beneficial than a winding up order;[5]
- whether there is a real prospect of refinancing and/or a sale as a going concern being effected; and
- the considered views of the board of directors of the company in question as to the best way forward.

EFFECT OF LIQUIDATOR'S APPOINTMENT

In an official liquidation, the Court will appoint official liquidators to wind up the affairs of the company, and their authority displaces that of the directors, who technically remain appointed but have no powers.

The official liquidators take control of the company's affairs, subject to the supervision of the Court. The primary function of official liquidators is to collect, realize and distribute the assets of the company to those entitled to them.

For provisional liquidators, there is no prescribed set of powers contained in the Companies Act or the winding up rules, but the provisional liquidators will have the powers set out in their appointment order, which may provide that the directors' powers cease upon the provisional liquidators' appointment, or provide for the directors to retain some powers.

In the case of a voluntary liquidation, the liquidator will be appointed by the shareholders or pursuant to the terms of the company's constitution and their remuneration is a matter for the shareholders to determine. As in an official liquidation, the directors are no longer in control of the company and have no powers. The function of a voluntary liquidator is the same as the official liquidator.

Upon the making of a winding-up order, or the appointment of provisional liquidators, there is an automatic stay which prevents any suit, action or other proceeding from being proceeded with or commenced against the company without the leave of the court.

The stay does not however prevent a secured creditor of the company from enforcing its security during the liquidation.

There is no such relief from potential claims being made against a company in voluntary liquidation.

POTENTIAL LIABILITIES

Investors and creditors of Cayman companies do not generally owe fiduciary duties to each other or the company and can therefore act in their own interests in pursuing the remedies set out in this article.

Investors, however, may well have a representative director on the board of directors. Directors do owe fiduciary duties to the company, including a duty to act in the best interests of the company. The "company" in this context means the company's stakeholders, which in the case of a solvent company means its shareholders, but if the company is insolvent or nearing the "zone of insolvency" the duty shifts to creditors.

The duty is owed to stakeholders as a whole (rather than to any individual shareholder, including the shareholder who appointed that director). Directors may find themselves in a difficult situation where they want to consider the interests of the shareholder that appointed them over the interests of other shareholders or creditors, and must therefore be very careful when acting to ensure that they do not breach the fiduciary duty owed to the company.

Directors of a Cayman Islands company will typically be indemnified by provisions included in the Articles of Association.

Case law has held that directors cannot be indemnified for willful neglect, willful default, fraud or dishonesty, but the Articles of Association typically exclude them from liability and indemnify them unless they have been guilty of willful default, fraud or (in certain cases) gross negligence. They are almost always indemnified for simple negligence.

Unless their actions fall within the realm of fraud or dishonesty or gross negligence (if relevant), the indemnities will therefore usually prevent the company or a liquidator acting on behalf of the company making a claim against the directors.

If liquidators are appointed, they have powers to avoid transactions which took place prior to their appointment, including the following:

- Any disposition of the company's property, transfer of shares or alteration in the status of its members after the winding up petition has been presented will be void, unless the Court orders otherwise, when a winding up order has been made.[6]
- Certain transactions in favor of a creditor may be a preferred transaction and therefore invalid if they were entered into:
- within six months preceding the presentation of a winding up petition;

- at a time when the company was unable to pay its debts;
- with a view to giving such creditor a preference over the other creditors (note that this intention is presumed if the transferee is a related party).[7]
- A disposition of property at an undervalue with intent to defraud creditors is voidable at the instance of an official liquidator, provided that the official liquidator must bring avoidance proceedings within six years of the disposition.[8]

As a result, anyone contemplating a transaction with a company, in circumstances where it is likely that that company will go into official liquidation, should ensure that they do not fall foul of these provisions and risk having the transaction set aside, if liquidators are subsequently appointed.

PROPOSED REFORMS

Although it is applied flexibly by the court and is workable in practice, the process for appointing provisional liquidators to undertake a restructuring is not entirely straightforward. In particular, a winding up petition, seeking the appointment of official liquidators, has to be filed before the company can apply for provisional liquidators to be appointed, and this can have unintended consequences in terms of reputational damage, and triggering events of default in the company's contractual arrangements.

The Cayman legal and financial services industry has therefore proposed amendments to the Companies Act which would allow a company, by its directors, to petition for the appointment of restructuring officers. A draft bill making the relevant amendments to the Companies Act was published for consultation in 2020.

CONCLUSION

As noted by the Chief Justice in the Sun Cheong case quoted above, the Cayman Islands is an advanced and reputable international financial center and its courts are well used to dealing with disputes between international parties. The courts take a flexible and pragmatic approach to assist investors and preserve value where possible.

It should go without saying that being well advised at the time that an investment is made, either debt or equity (or both), will go a long way towards ensuring that you are well aware of the options under Cayman law and are able to negotiate appropriate terms at the outset of any investment.

However, that isn't always possible and if you are now or in the future facing any of the issues set out in this article, we recommend you seek Cayman legal advice without delay. You may be surprised at the remedies that are available in the Cayman Islands, and you will also want to ensure that you do not expose yourself to liabilities or risk transactions being set aside under Cayman law.

Notes

[1] In the Matter of Weavering Macro Fixed Income Fund Limited (in liquidation) [2016 (2) CILR 514].

[2] Companies Act (2020 Revision), section 104(3).

[3] Unreported, decision of Chief Justice Anthony Smellie dated 20 October 2020.

[4] [2004-5] CILR 213

[5] In this case, the application was supported by a report from FTI Consulting (Hong Kong) Limited as Independent Financial Advisor, which confirmed that it was.

[6] Companies Act, section 99.

[7] Companies Act, section 145.

[8] Companies Act, section 146.

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