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ARTICLE

Transaction Avoidance in the Cayman Islands Insolvency Context: Voidable Preferences under s145 of the Companies Act

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Synopsis

The principle underlying the collective insolvency procedures of liquidation and bankruptcy is, in simple terms, that an insolvent debtor's available assets should be distributed amongst its creditors fairly. It runs contrary to that principle, and contrary to the interests of a creditor body as a whole, for an insolvent debtor to determine for itself how its assets ought to be applied.

In the Cayman Islands, as elsewhere in the common law world, there is a suite of statutory provisions designed to remedy that mischief by enabling certain transactions to be avoided in favour of a collective *pari passu* scheme of asset distribution. These provisions, which are found in the Companies Act,[1] concern voidable preferences (under section 145), the avoidance of dispositions at an undervalue (under section 146), and a fraudulent trading provision (under section 147).

The focus of this article is on voidable preference claims under section 145: the requirements that must be met, the differences between section 145 and equivalent provisions in certain other common law jurisdictions, and a review of the surprisingly limited number of legal authorities on the subject (the two most important of which concern redemptions from investment funds suffering catastrophic losses).

Section 145 of the Cayman Islands Companies Act

Section 145 provides that:

> '(1) Every conveyance or transfer of property, or charge thereon, and every payment obligation and judicial proceeding, made, incurred, taken or suffered by any company in favour of any creditor at a time when the company is unable to pay its debts within the meaning of section 93 with a view to giving such creditor a preference over the other creditors shall be invalid if made, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation.
>
> (2) A payment made as aforesaid to a related party of the company shall be deemed to have been made with a view to giving such creditor a preference.
>
> (3) For the purposes of this section a creditor shall be treated as a "related party" if it has the ability to control the company or exercise significant influence over the company in making financial and operating decisions.'

What is meant by the expression 'with a view to' giving a preference?

The drafting of Section 145 can be traced back to the laws concerning voidable preferences contained in the English Bankruptcy Act 1914 and the Companies Act 1948. What is required is that the liquidator must prove that the insolvent debtor's *dominant or sole intention* is to prefer the creditor.

Some commentators have described this requirement as leading to a distinction between 'bad' and 'good' preferences, such that only those transactions that are motivated by a dominant intention to prefer will be set aside. Where, for example, creditors have obtained payment (and therefore an advantage over other creditors) as a result of exerting pressure on the debtor to repay, the transaction in question is not objectionable and will not constitute a voidable preference.[2]

This point was first addressed in the Cayman Islands in *Segoes Services Ltd v Ueoka* [2006] CILR N [1]. There a director had preferred his wife over other creditors while knowing that the company was insolvent and other creditors had demanded payment. The Court

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1 It is worth noting that Section 4 of the Fraudulent Dispositions Act provides that every disposition of property with an intent to defraud and at an undervalue shall be voidable at the instance of a creditor thereby prejudiced. However, a disposition that is set aside under that law is set aside only to the extent necessary to satisfy the obligation to a creditor at whose instance the action was brought (in addition to any costs as may be allowed). The Fraudulent Dispositions Act operates both within and outside of the insolvency context.

2 See the discussion in Parry, Ayliffe QC and Shivji, *Transaction Avoidance in Insolvencies* (3rd edn), at [2.39 et seq.].

found irresistible, in that case, the inference of a dominant intention to prefer.

The dominant intention issue was then addressed in greater detail by the Chief Justice of the Cayman Islands in *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund* [2014 (2) CILR 316], a case concerning the inflation of a master fund's net asset value (upon which redemptions and subscriptions to were based) following its insolvency in the wake of the 2008 financial crisis. One of the investors in a feeder fund, following the submission of a redemption request in respect of part of its investment, applied substantial pressure on the feeder fund by making several unscheduled visits to its offices, sending several requests for further information, threatening further redemptions and taking legal action to enforce the debt owing. The key issue was whether the feeder fund, by subsequently making certain redemption payments to that particular investor over and above what it paid to other investors, had evinced a dominant intention to prefer.

The Court in that case found no intention to prefer, on the basis that the payments had been motivated by unrelenting and escalating pressure. Accordingly, and consistent with earlier decisions of the English courts,[3] the Court emphasised the requirement to consider all the circumstances under which the impugned payment was made in order to discern what the underlying *motive* of the payment is. If the motive is not impelled predominantly by an intention to prefer, but by some other reason (for example, to relieve a threat, to avoid the detection of an illegal act, or to 'postpone the evil day' of detection of insolvency), there can be no avoidance.

The Cayman Islands position – a comparison with other jurisdictions

Arguably, the relevant thresholds for a payment to be avoided as a voidable preference are higher in the Cayman Islands than elsewhere.

In England and Wales, following the recommendations of the Cork Committee which led to the enactment of the Insolvency Act 1986, the position has now changed. Now the relevant test is whether the debtor, in respect of the relevant transaction, is 'influenced by a desire' to benefit a particular creditor (or surety or guarantor). As such, although the English position still necessitates an examination of the motivation behind the payment, there is a different test, and one that is easier for liquidators to satisfy (there being a requirement to show 'a desire' but not a 'dominant intention').[4]

In Australia, a transaction constitutes an unfair preference if it *results* in the creditor receiving more than the creditor would receive from the debtor in respect of its debt if the transaction were set aside and the creditor were to prove for its debt in a winding up. There is, accordingly, no examination of motive at all; instead the focus is simply on the *effect* of the payment.[5]

In the United States a similar scheme applies. Under the US Bankruptcy Code, subject to certain exceptions, creditors are required to repay any sums paid back into the debtor's estate, where the debtor files for bankruptcy within 90 days.[6]

Payments to connected parties

Of note in relation to the Cayman Islands regime is that where the payment in question has been made to a connected party (viz., a creditor with the ability to control the company or exercise significant influence over financial and operating decisions), the payment is *deemed*, as a fait accompli, to be a preference, with the effect that there is no need for the liquidator to demonstrate an intention to prefer. The position is once more different to England and Wales, where payments to connected parties only create a *rebuttable presumption* as having influenced the desire to make the payment.[7]

Temporal considerations

There are two key temporal limitations to be borne in mind under Section 145 of the Companies Act:

- *First*, the relevant preference must have taken place within six months immediately preceding the commencement of a liquidation. Save in certain limited circumstances (for example, where there has been a resolution passed by the company for a voluntary winding up beforehand), under Cayman Islands law, a winding up is deemed to commence at the time of presentation of the petition.
- *Secondly*, the company must have been unable to pay its debts when the relevant preference was made; it must have been insolvent.

Inability to pay debts

As to the second of these requirements, in summary, a company is deemed to be unable to pay its debts under

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3 For example, *In re Cutts* [1956] 1 W.L.R. and *In re M Kushler Ltd* [1943] Ch. 248.
4 This was referred to as a 'radical departure' from the dominant intention test in *Re M C Bacon Ltd* [1990] BCC 78.
5 Corporations Act 2011 Sect 588FA(1).
6 Bankruptcy Code §547.
7 Insolvency Act 1986 s239(6).

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Cayman Islands law if: (i) it receives a statutory demand in respect of a due debt exceeding KYD$100 and fails to pay, secure or compound for that debt to the creditor's satisfaction; (ii) execution issued on a judgment in favour of any creditor is returned unsatisfied in whole or in part; or (iii) it is proved to the satisfaction of the Court that the company is unable to pay its debts.

The Cayman Islands Court of Appeal in *In re Weavering* [2016] (2) CILR 514 has confirmed that the relevant test for insolvency in the Cayman Islands is the cash flow test, rather than the balance sheet test. Notably, that test is not confined to debts that are immediately due and payable. Debts that will become due in the reasonably near future may also be taken into account: 'Any other conclusion leads to artificiality: if a company is able to pay a small debt due on a particular day, but will inevitably be unable to pay a much larger debt due on the following day, it is artificial to say that on the first day it is not unable to pay its debts.'[8]

The consequences of the application of Section 145

In England and Wales the court is required, upon an application by the liquidator, to make an order as it sees fit for restoring the position to what it would have been if the company had not made the preference payment.[9] There is no such requirement in the Cayman Islands, where the Companies Act is silent on what happens next. It is important to note, in this respect, that the invalidation of a disposition of property and the recovery of the property disposed of, are two logically distinct matters.[10]

In the absence of a statutory scheme, the consequences of the application of section 145 are instead regulated by the general law: in other words, by any other statutory provisions which may be applicable in the circumstances, or alternatively (in the absence of those statutory provisions) by the common law.

The effects of a payment being held to be a preference have been addressed in considerable depth at the highest appellate level, in the Judicial Committee of the Privy Council's decision in *In re Weavering* [2019] UKPC 36. *Weavering* concerned the fraudulent inflation of a fund's net asset value and the proposed claw-back of redemption payments that had been made shortly before the commencement of the fund's liquidation. The recipient of those redemption payments argued that to the extent the payments were voidable under section 145, the liquidators' claim to restitution arose under the common law and was based on unjust enrichment. It was argued by the recipient that it was therefore entitled to raise alternative defences: *first*, that it had not been enriched (the recipient had received the funds in its capacity as custodian, as nominee on behalf of its underlying clients); and *secondly*, that it had changed its position by transmitting the proceeds onwards to those clients.

The Privy Council held that the consequences of the avoidance of a fraudulent preference, depending on the general law, will vary according to the circumstances. In principle, where property has been transferred and remains in the hands of the transferee, the consequence of avoidance is that the liquidator may have a claim to recover that property. Where, however no claim is advanced on a proprietary basis (as was the case in *Weavering*), but a payment has been made, in principle the liquidators are entitled to restitution of that payment at common law on unjust enrichment grounds.

(Non-)availability of common law defences

That being the case, the Privy Council went on to consider the two common law defences that had been advanced. On the first issue of non-enrichment, it was held that the creditor had in fact been enriched notwithstanding that it received the money as trustee. This is because the common law ignores the equitable interest of the beneficiaries. The recipient was therefore an appropriate defendant.[11]

As to the change of position defence, the key issue was whether the common law gives priority either to the operation of the statutory scheme of collective distribution, or to the detrimental impact which recovery of that payment may have on a creditor that has since paid away the money. The Privy Council held that the statutory scheme of collective distribution has primacy. Accordingly, as a matter of Cayman Islands law, a change of position defence is unavailable within the context of section 145 voidable preference actions. This is the case notwithstanding the Privy Council's express acknowledgment that the non-availability of a change of position defence may be capable of leading to harsh results.

Notes

8 *Weavering* [2016] (2) CILR 514 at [40].

9 Insolvency Act 1986 s239(3). Seven different types of order, without prejudice to the generality of Section 239, may then be made. These are listed at s241(1) and include orders for the repayment of money, the re-vesting of transferred property in the company and the release or discharge of any security given by the company.

10 See for example *In re J Leslie Engineers Co Ltd* [1976] 1 WLR 292.

11 The position is different where the recipient receives the payment in an agency capacity: *Portman Building Society v Hamlyn Taylor Neck (a Firm)* [1998] 4 All ER 202.

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