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Contingent and prospective creditors and Cayman Islands insolvency

BACKGROUND

Following the Cayman legislature's decision to exclude from the 2007 amendments to the Cayman Companies Law a balance sheet test for insolvency, the test for insolvency in the Cayman Islands has been taken to be, exclusively, a cash flow test.

In 2009, amendments to the Companies Law added to the Companies Law a right of contingent and prospective creditors to petition for the winding up of a company. Prior to that amendment, contingent and prospective creditors were precluded from petitioning to wind up a company on the grounds of the inability of a company to pay its debts.

The grant to contingent and prospective creditors of an entitlement to petition juxtaposed with the omission of a balance sheet test for insolvency from the Companies Law raises a number of conceptual issues and contradictions when comparative provisions from other jurisdictions are considered. While many petitions brought by contingent and prospective creditors may be determined without risk of these issues being in play, the issues discussed in this note may well arise in other cases that will come before the Cayman Court.

This article will attempt to foreshadow some of those issues, examine the nature of the legislative conflict and suggest appropriate statutory interpretation and/or amendment to deal with the problems presented by the interaction of the relevant provisions of the Companies Law.

Consideration will also be given to whether the new right of contingent and prospective creditors to petition to wind up a company will circumvent the barriers erected against unpaid redeeming fund investors by the *Strategic Turnaround Master Partnership* case.

WHAT THE AMENDMENTS TO THE CAYMAN COMPANIES LAW MEAN

Section 94(1)(b) of the Companies Law now includes contingent or prospective creditors in the list of parties who may petition to wind up a company. This amendment gives *locus standi* to those creditors with contingent, future or unascertained debts to petition the court for a winding up order.

The amendment does not purport to alter the basis for determining whether a company is or is not insolvent, but rather gives contingent and prospective creditors the right to initiate the collective winding up process. By reason of s 94(1)(b), contingent and prospective creditors are able to petition the court for a winding up order on the grounds of a company's inability to pay its debts, notwithstanding that the contingent and prospective creditor's own debt has not yet fallen due.

It is not the case, however, that a contingent or prospective creditor's role in the determination of the company's insolvency is limited to that of a bare right of initiation of the collective process. There is no express restriction of this kind and, indeed, it would defy common sense to interpret the amendment in that manner. In certain cases, large and closely imminent debts may be an overwhelming factor in determination of whether a company should be wound up.

In practice, the contingent or prospective debt may not be a central consideration particularly often, since the quantum of the company's presently due debts may be sufficient to determine the company's insolvency or otherwise. Even if the petitioner's own contingent or prospective debt is taken directly into account, the evidentiary weight of such a contingent liability in the court's assessment of insolvency is also likely to be variable in case-to-case, as it will be a particularly fact-dependant liability of the company, and uncertainty as to the company's future cash flow may make the analysis of little probative value.

Nevertheless, the issues raised by the contradictions identified in this paper are sufficiently structural to the Cayman Companies Law that they require elucidation and resolution in order that the Cayman legal fraternity may properly advise its clients on the principled basis for and extent of contingent and prospective creditors' relevance to a determination of the insolvency of a Cayman Islands company.

THE UK PROVISIONS

Given that Cayman Islands legal system is based upon the English system, like and related provisions in the UK legislation are relevant to the issues discussed in this paper.

In post-1985 UK legislation, the liabilities of contingent and prospective creditors have been treated as a function of the balance sheet assessment of a company's insolvency. Section 123(2) of the Insolvency Act 1986 ('IA 1986') provides that a company can be adjudged insolvent on a balance sheet test (in alternative to a cash flow test) where 'the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities'.

The separation, in the UK, of a cash flow test for insolvency from the treatment of contingent and prospective liabilities is reinforced in notable commentaries. The *Annotated Guide to Insolvency Legislation* states, for example, that:

'Paragraph 123(1)(e) (as [Companies Act 1985] s.518(1)(e)) formerly read: "if it is proved to the satisfaction of the court that the company is unable to pay its debts (and, in determining that question, the court shall take into account the company's contingent and prospective liabilities)". This formula was unhelpful in that it ran

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together two issues: (1) the question whether current debts could be met as they fell due, ie “commercial” solvency; and (2) the question whether the company would ultimately prove solvent if its future as well as its present liabilities were brought into the reckoning. The confusion was resolved by the amendment made by [the Insolvency Act 1985]: contingent and prospective liabilities are no longer to be taken into account for the purposes of paragraph 123(1)(e), while insolvency calculated on a balance-sheet basis becomes a separate test under s.123(2).’

Further, in the 3rd edition of *The Law of Insolvency* (2002), Professor Fletcher assumes that contingent and prospective liabilities have no part to play in the cash flow evaluation of a company’s affairs.

If these comments are correct and relevantly apply in the Cayman Islands, the consideration of contingent and prospective liabilities can only properly occur in connection with the assessment of the net asset/net liability position of the company; that is as part of a balance sheet test. However, the Cayman Islands legislature chose not to include such a test in Cayman’s insolvency legislation and only has a cash flow test for insolvency.

Furthermore, the difficulty caused by the juxtaposition in Cayman of contingent and prospective liabilities with a cash flow test rather than a balance sheet test is accentuated by the fact that the cash flow test in s 93(1)(c) materially differs from that in s 123(1)(e). In the UK, the trade-off for contingent and prospective liabilities being removed from the equivalent of s 123(1)(e) and transposed into the balance sheet provision of s 123(2) in 1985 was that the cash flow provision had added to it the words ‘as they fall due’. While there is not consensus on the point, those words have been held to connote some element of futurity (all be it of uncertain degree) into the UK cash flow test.

Contrary to the UK provision and to other jurisdictions (such as Australia) that have only a cash flow test, the Cayman provision does not include such language. Instead, s 93(1)(c) only requires that it is proved to the satisfaction of the court that the company is unable to pay its debts.

The cumulative decisions of the Cayman legislature (a) to omit a balance sheet test for insolvency, (b) not to include language of futurity in the cash flow test, and (c) to give contingent and prospective creditors standing to petition based on debts not due, make uncomfortable bedfellows. The first two decisions point towards a narrower cash flow-based test for insolvency, yet the third introduces a concept that has been historically associated with a balance sheet test or a wider interpretation of the cash flow test. The current Cayman Islands law is, in this regard, anomalous.

RESOLUTION OF THE CONTRADICTION

In the writer’s view, absent statutory amendment, the most useful pointers to an appropriate resolution of the above conceptual contradictions are as follows:

1. Recognition of the lack of practical use or legislative justification for a stringently singular cash flow test in the Cayman Islands.
2. Taking into account the obiter statements of Briggs J in *Cheyne*

Finance plc [2008] All ER 987 in respect of future debts and their relevance to cash flow tests for insolvency.

3. The treatment of contingent and prospective liabilities in other jurisdictions, such as Australia, which have no balance sheet test, or more particularly, the interpretation of the cash flow test in such jurisdictions.

Application of the cash flow test

Despite the non-inclusion of the words ‘as they fall due’ in s 93(1)(c), the language of the provision (‘it is proved to the satisfaction of the Court that the company is unable to pay its debts’) lends scant support to the view that the provision operates strictly as a cash flow test.

Further, irrespective of academic classification, as a matter of practical application of the test set out in s 93(1)(c), the assessment of a company’s insolvency pursuant to that section will be richly fact-dependent. Whether a company will be wound up on the grounds of being unable to pay its debts will be determined by the court having

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reference to all of the available evidence, albeit that the company’s liquidity will be central to the court’s decision. While the court would be unlikely to wind up a company on the basis of balance sheet considerations alone, it would be equally as unlikely to disregard key financial considerations (together with liquidity issues) because they could be construed as balance sheet-related factors.

Future debt and *Cheyne Finance plc*

Although yet to be followed in the Cayman Islands, the decision of Briggs J in *Cheyne Finance plc* [2008] All ER 987 raises important issues in this context, notwithstanding that it was considering the UK insolvency provisions.

The court in *Cheyne Finance* found that a contractual provision which stipulated that insolvency be measured solely by reference to s 123(1)(e) (the UK cash flow test) did not preclude the consideration of prospective creditors, despite such creditors only being referred to in s 123(2) of the IA 1986.

Briggs J placed considerable reliance upon Australian authorities and the parity between the language of s 123(1)(e) and s 95A of the Australian Corporations Act with regards to consideration of debts ‘as they fall due’/‘become due and payable’. As noted earlier, the Cayman iteration of the cash flow test does not include such language.

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While a company responding to a petition where future or contingent debts were important would seek to disapply *Cheyne Finance* because of this difference, it is important to recognise the sound and applicable reasoning of Briggs J's judgment. Passages such as that quoted below can be applied to the Cayman legislative scheme despite the language of 'as they become due' not being present in s 93(1)(c):

'It is clear from a review of the Australian decisions that in an environment shorn of any balance sheet test for insolvency, cash flow or commercial insolvency is not to be ascertained by a slavish focus only on debts due as at the relevant date. Such a blinkered review will, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases fail to see that due to an endemic shortage of working capital a company is on any commercial view insolvent, even though it may continue to be pay its debts for the next few days, weeks or even months before an inevitable future.'

While the present state of the Companies Law is unsatisfactory and it is uncertain whether the Grand Court will be persuaded to follow the reasoning of Briggs J in *Cheyne Finance*, it is submitted that (pending any statutory amendment) his wider interpretation and application of the cash flow test is strongly to be preferred.

Treatment of like legislation in other jurisdictions

Section 95A of the Australian Corporations Act 2001 contains a cash flow test for insolvency similar to that in the Cayman Islands (absent the words 'as they become due and payable'). There is no balance sheet test in the Australian legislation.

As Briggs J noted in *Cheyne Finance*, despite the test for insolvency in Australia not including a balance sheet test, future debts are considered in relation to satisfaction of the s 95A requirement. In the Australian case of *Lewis v Doran* [2005] NSWCA 243, for example, the relevance of future debt was acknowledged, it being a consideration that is fact-sensitive and dependent upon the company's future liabilities, the nature of its business, and the existence of sufficient evidence of cash flow insolvency for the future debt.

Although the presence of language associated with futurity is a factor, Australian jurisprudence accommodates contingent and prospective claims despite the absence of a balance sheet test for insolvency because a realistic and practical interpretation is taken of the cash flow test. The following excerpt from an Australian Federal Court judgment is representative of the approach that is taken in Australia to determining insolvency against the legislative background of a cash flow test:

'The issue of solvency is a factual matter which must be resolved having regard to the definition to which I have referred. The definition suggests that the issue of solvency needs to be resolved by having regard to the cash flow of a company but, of

course, the sum total of its assets and liabilities, as disclosed in the balance sheet, is not irrelevant. In this case, Mr Cooper has examined the company's financial position having regard to three separate approaches. He has analysed the company's cash flow over the relevant period. He has had regard to the balance sheet. Lastly, he has reviewed anecdotal evidence to determine whether that evidence points to insolvency. I have considered the material upon which Mr Cooper based ... [his] ... opinion ... [that the company was and remained insolvent] ... and I am satisfied that that material supports the opinion offered. I accept that opinion.'

In the above case, despite the Australian Corporations Act having a cash flow test for insolvency (in effectively similar terms to the Cayman Islands provision), the Federal Court of Australia referred to the company's working capital deficiency which was measured by having regard to the available current assets to pay the necessary current liabilities, and the fact that the company was under continual pressure from its creditors to pay overdue debts, as well as referring to the company's chronic deficiency in cash flow. The Australian Court reached its determination on the company's insolvency after reference to the totality of the evidence under the various forms of analysis, unfettered by any notion of cash flow being the sole test for insolvency.

This approach is mirrored in other Australian cases such as *Taylor v Australia* and *New Zealand Banking Group Ltd* (1988) 13 ACLR 780 in which McGarvie J stated that the question of whether a company was able to pay its debts as they fell due was a question of fact to be decided 'as a matter of commercial reality in light of all the circumstances'.

The Australian approach is not dissimilar, in practice, to the approach that the Grand Court takes and has taken even prior to recent amendments in determining insolvency of Cayman Islands companies. Given this is the case, the conceptual inconsistencies and anomalies identified in this paper will not arise to any significant extent if the court continues to treat s 93(1)(c) as essentially a liquidity test underpinned by a wider review of the company's overall financial position.

Should the alternate path of a narrow and strict cash flow test approach be taken, the recent enhancement of contingent and prospective creditors' rights (and the necessary inclusion of their claims in determining insolvency) would become problematic or even unworkable. The writer sees no need or justification for such an unduly restrictive interpretation of s 93(1)(c) to be taken, although submissions in future cases may well require the Grand Court to rule on these matters.

THE PRESENT LAW AND STRATEGIC TURNAROUND MASTER PARTNERSHIP

A further conundrum posed by the addition of a right of contingent and prospective creditors to petition on the grounds of inability to pay debts is whether the recent ruling in *Strategic Turnaround*

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Biog box

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Master Partnership still prevents a redeeming shareholder/fund creditor from petitioning in respect of its future debt.

The class of redeeming investors caught by *Strategic Turnaround* (that is those prevented from petitioning on the grounds of non-payment) are those shareholders who lodged redemption requests in respect of a date for payment that has not passed or the fund resolved prior to that date to suspend payment of redemptions. Although a redeeming shareholder may be described as a 'creditor', their correct status is a fund creditor or a creditor qua shareholder, rather than an external creditor, *per se*.

Although the fund's constitutional documents, will need to be considered in each case, notwithstanding the characterisation of suspended redeemers in the *Strategic Turnaround* case, it is difficult to resist the argument that suspended redeemers – being parties whom

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are owed their redemption sums at some future date upon lifting of suspensions – are contingent and prospective creditors. On this basis, absent any relevant restrictions in the investment contract, suspended redeemers may at least have the *locus standi* to petition for the winding up of the fund. There is no obvious reason why the addition to Cayman Companies Law of a right in contingent and prospective creditors to petition to wind up would not extend to creditors who are contingent by reason of the suspension of redemptions and the effect of the *Strategic Turnaround* decision and until the law is amended or clarified, it is a fair assumption that unpaid redeemers may be entitled to petition, despite suspension of redemptions, in particular where the suspension has become protracted and contentious. The fate

of such petitions is difficult to predict; however, there is at least an arguable case that they should be entitled to be presented.

The current contradictions in the Companies Law are also likely to be relevant to what remains of the structured finance industry. The balance sheet test for insolvency was, in large part, omitted from the 2007 amendments due to lobbying by the representatives of the structured finance industry who were concerned that Structured Investment Vehicles ('SIVs') and like vehicles could be held balance sheet insolvent from the outset. The present inclusion of balance sheet-type/future debt considerations could be of similar concern to the promoters of such investment vehicles and indeed to hedge fund and mutual fund structures. The most economical method of neutralising such concerns would be for SIVs, funds and other investment vehicles to include in their contractual provisions, anti-petition covenants. The 2009 amendments to the Companies Law include a provision that any contractual provisions prohibiting the filing of winding up petitions will be upheld by the court. As a result, we are likely to see increasing use of anti-petition clauses in the contractual documents in a multitude of investment vehicles in order to avoid the possibility of investors seeking to petition to wind up the company concerned prior to the final date for payment of redemption entitlements having passed.

CONCLUSION

There is a strong case for amendment of s 93(1)(c) to include language, similar to that in the UK and Australia, importing into the cash flow test some element of futurity of debt.

In the event that such an amendment is not made, the Grand Court will need to take a robust approach to the application of the cash flow test where contingent and prospective liabilities feature prominently in the assessment of a company's insolvency, if the pitfalls created by the anomalies in the Companies Law are to be avoided.

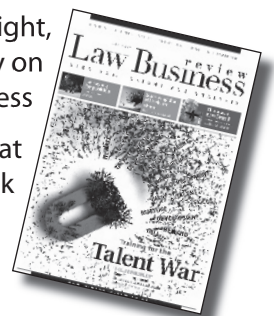
The inclusion of the contingent and prospective creditors in the list of those who may petition to wind up undermines the attempts to insulate certain investment vehicles from being assessed for insolvency with reference to future debt. In the interim, this is likely to result in the inclusion of specific contractual provisions to deal with this threat. ■

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