



Guide to Cayman Islands Insolvency

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PREFACE

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The insolvency law of the Cayman Islands, which is primarily embodied in the Companies Law and Companies Winding-Up Rules, was the subject of a major overhaul in 2009, bringing the insolvency regime up to date, introducing some new concepts, improving the options available to creditors and formalizing the system for cross-border co-operation in insolvency proceedings. The regime bears a number of similarities with the insolvency regimes of the many jurisdictions whose law is based on that of England and Wales, but also some important differences.

The Cayman Islands has long been regarded as, and continues to be, a creditor-friendly jurisdiction. Cayman insolvency law follows a universalist, rather than territorial approach to creditor rights, in that creditors are not treated differently based on whether they are based in Cayman or elsewhere. The territory has been a progressive proponent of the principles of international co-operation and comity that underpin cross-border insolvency laws in Europe and the United States.

WHEN IS A COMPANY INSOLVENT UNDER CAYMAN ISLANDS LAW?

A company will be insolvent in the Cayman Islands when it is unable to pay its debts. A company is deemed to be unable to pay its debts, and therefore to be insolvent, if the company does not satisfy a creditor's statutory demand within 3 weeks; if an order, judgment or decree in favour of a creditor is returned unsatisfied in whole or part; or if it is otherwise proved to the Grand Court's satisfaction that the company is unable to pay its debts.

When considering whether a company is unable to pay its debts, the test applied in the Cayman Islands is essentially a cash-flow test, determined as a matter of objective assessment of the whole of the evidence as to the company's financial position and its ability to meet its present liabilities from its available assets.

There is no balance sheet test for insolvency. However a recent change to the Companies Law (giving contingent and prospective creditors standing to petition to wind up a company) confirms that in addition to the company's capacity to pay presently due debts, the Cayman Court will give some consideration, at least, to future debts and the ability of the company to meet those debts from future cash flow. This is a developing area of Cayman law and the question will be heavily fact dependant. It is therefore recommended that advice be sought on a case by case basis.

FORMAL INSOLVENCY PROCEDURES

The formal insolvency procedures are limited to liquidation and schemes of arrangement. There is no direct equivalent to the English concept of company administration or to the Chapter 11 process in the United States.

A liquidation may be voluntary (where there is no requirement for court involvement), a court supervised voluntary liquidation or a compulsory liquidation by the court.

Voluntary liquidation

Subject to the terms of a company's Articles of Association, a Cayman Islands company can be placed into voluntary liquidation pursuant to a special resolution without any formal court process. A voluntary liquidator does not need to be a professional insolvency practitioner, but may be one (or more) of the directors, the company's accountant or some other appropriate party.

A liquidation can only continue as a voluntary liquidation if, within 28 days of the liquidator's appointment, the directors make a sworn declaration of solvency, in essence stating that the company can pay all of its creditors in

full within 12 months of the liquidator's appointment. Without that, the liquidators are obliged to apply to bring the liquidation under the supervision of the court. Voluntary liquidation is therefore not a long-term option for insolvent companies, although it can be used where the company is or may be insolvent as a means of expedited appointment of a liquidator. In such a case, where the voluntary liquidation is simply a precursor to an application for the voluntary liquidation to be court-supervised (because the company is insolvent) insolvency practitioners are usually appointed at the outset of the voluntary liquidation.

Court-supervised liquidation

Once a voluntary liquidation becomes court-supervised the court-supervised voluntary liquidator has virtually identical powers to a liquidator appointed pursuant to a compulsory liquidation process.

Compulsory liquidation

A petition for the winding-up of a company may be issued by the company itself, by a creditor (including contingent and prospective creditors), by a contributory or, if company is regulated, by the Cayman Islands Monetary Authority.

The bases upon which a compulsory winding up order of the Court may be sought are (a) where the company has passed a special resolution requiring such winding up (b) where the company's business is suspended for a whole year (c) where a date for winding up stipulated in the company's articles expires (d) where the company is unable to pay its debts (e) where the Court is of the opinion that it is just and equitable that the company should be wound up. Of these grounds, only insolvency and the "just and equitable" ground are common. The test for insolvency is discussed above.

A petition on the "just and equitable" ground is commonly presented where there has been some serious mismanagement, breach of fiduciary or fraud by the company's directors or where the company is a quasi-partnership and in deadlock. It can also succeed where the court is persuaded that the 'substratum of the company' – its whole reason for existence – has fallen away. While the categories of case in which an order can be made are not closed, the burden on a petitioner seeking to wind up on just and equitable grounds is a fairly heavy one and clear evidence must be adduced to persuade the Court that it is appropriate that the company be wound up on just and equitable grounds.

No petition to wind up a company (on any grounds) will be permitted to proceed where the Articles of Association or other document forming part of the contract between the company and the creditors and/or shareholders includes a provision that the relevant party shall be contractually bound not to present a petition.

In a liquidation, of any type (other than provisional liquidation – see below), all assets are collected and distributed, the liquidator released and the company dissolved.

Provisional liquidation

Following the filing of a petition for a compulsory winding-up but prior to the hearing of that petition, in an appropriate case, the petitioner may apply to the court for the appointment of a provisional liquidator.

A provisional liquidator may be appointed for the purposes of preserving the assets of the company, managing the company's business, permitting the investigation of the company's affairs or taking any other steps for which there is a pressing and real need. The appointment is intended to be temporary, but it is the usual practice that on

granting a winding up petition, the provisional liquidators will remain in place as Official Liquidators for the company. At the same time as granting an order appointing provisional liquidators for the company, the Court may make an order restraining any further legal proceedings against the company on such terms as it thinks fit.

Although there is no express statutory jurisdiction to do so, the appointment of a provisional liquidator has on occasion been used in Cayman to achieve the same ends as an Administration order in England or a Chapter 11 proceeding in the USA; i.e. to obtain a moratorium on the enforcement of claims against the company so as to enable a more advantageous realisation of its assets, and possibly to work its way out of insolvency. The procedure involved is to present a petition for the winding up of the company and apply (normally ex parte) for a stay of all proceedings against the company and for the appointment of one or more Provisional Liquidators to preserve and maintain the company's assets. The Cayman courts have been prepared to make such orders even where it is not intended to proceed with the winding up Petition and appoint Official Liquidators, for example where the company is to embark on a refinancing or corporate reorganisation. The Petition itself is then normally adjourned periodically and ultimately dismissed. In this way, the company can avoid the deleterious consequences of being placed into liquidation while making full use of the advantages of the moratorium on enforcement that normally follow the appointment of liquidators. However, it is important to recognize that this approach is not the same as administration or Chapter 11, and in particular does not permit any variation of creditors' rights, other than by enabling a scheme of arrangement.

Scheme of arrangement

A scheme of arrangement is a court approved compromise or arrangement entered into between a company and its creditors or members or any classes of them.

In Cayman, creditor schemes represent the only formal means of imposing corporate rescue of a distressed and insolvent company. Such schemes are often used in conjunction with the appointment of provisional liquidators. This enables the company to take advantage of the statutory moratorium on claims, so allowing the provisional liquidators and the company's principal creditors to assemble the restructuring proposal without a myriad of creditor claims being enforced.

A special category of compromise or arrangement is an amalgamation by which the Grand Court can order transfers (between the companies to be amalgamated) of assets and liabilities (including legal proceedings), the dissolution (without winding up) of the transferring company and incidental matters.

An application for a scheme of arrangement is commenced by petition, filed at the Grand Court. The application may be commenced by the company or a member, creditor or liquidator of the company. The petition seeks the Court's sanction of a proposed scheme of arrangement or compromise.

The process usually involves four stages. At the first the court will be asked to approve the convening of meetings of the classes of creditors or shareholders affected. Then the meetings are held and the stakeholders vote on the scheme. If each class meeting approves the scheme by a majority in number representing 75% in value of the class, the scheme goes back before the court for final approval. This is not a mere formality, and the court can refuse sanction even if the required majority has been obtained, if it considers that the rights of any minority are being unfairly prejudiced. However if approval is given, the scheme will bind all of the company's creditors, including those who opposed its terms. The fourth and final stage sees the terms of the scheme being carried into effect.

CREDITORS' RIGHTS

Secured creditors are free to enforce their security despite the insolvency of the chargor company and the commencement of any of the above formal insolvency procedures.

The appointment of a voluntary liquidator does not prevent actions and enforcement measures being taken against the company by unsecured creditors.

If a voluntary liquidation becomes court-supervised, the statutory stay of proceedings against the company automatically comes into effect. That stay also applies immediately upon the appointment of a liquidator through the compulsory liquidation process.

Mutual credits and set-off insolvency rules apply in the Cayman Islands, automatically applying a netting-off of claims and debts of creditors and the company in liquidation.

Creditor schemes are usually run in conjunction with provisional liquidations in order to obtain the benefit of the stay of proceedings, thereby preventing unsecured creditor enforcements unless otherwise ordered by the Court. The rights of creditors in a scheme of arrangement will vary according to the terms of the particular scheme.

In almost all compulsory liquidations, the official liquidator is required to establish a liquidation committee of three to five creditors. The committee has a right to information and reports and can appoint its own counsel. Its members must also be given notice of, and can appear at, any application by the liquidator for the court's sanction of the exercise of any power for which sanction is needed.

VOIDABLE TRANSACTIONS

Any disposition of the property of a company after the filing of a petition for the winding up of company is void upon the making of a winding up order, unless approved by the Court.

A disposition in favour of a creditor by an insolvent company, for the purposes of preferring that creditor, within 6 months prior to the filing of a petition for winding up, is void.

Transactions made for the purpose of defrauding creditors within 12 months of the winding up constitute an offence punishable by pecuniary penalty and custodial sentences.

A transaction at an undervalue for the purpose of defeating an obligation owed to a creditor is voidable by any creditor prejudiced by the transaction. The action to set it aside must be commenced within 6 years of the disposition.

Where the liquidator is of the view that fraudulent trading has occurred, the liquidator may seek a declaration from the Cayman Court that parties knowingly involved in the fraudulent transaction contribute to the assets of the company. An order under this provision may be made against, among others, the directors of the insolvent company.

There is no statutory provision dealing directly with insolvent trading in the Cayman Islands. Directors may be liable for breach of their fiduciary obligations, however, if the company continues to incur liabilities at a time when there is no prospect of the company trading out of its financial difficulties.

OTHER CONSEQUENCES OF FORMAL INSOLVENCY PROCEDURES

Liquidation

Upon the appointment of a liquidator, whether voluntary or compulsory, the powers of the directors cease. Transfers of shares and alterations in the status of members that take place after the issuing of the petition are void, unless the Court otherwise orders.

Employment contracts will often specify the effect of the liquidation of the employer but in the majority of cases, unless otherwise required by the liquidator, employment contracts will be terminated. Employee wages claims have a priority over other debts of the company, to a limit of \$100.

Liquidation does not automatically terminate contracts, although particular contracts may provide for termination on that event. In practice, however, the majority of contracts will not continue once a company enters liquidation. Claims for damages for breach of contract and for debts of the company arising under the contract prior to liquidation can be claimed in the liquidation.

Scheme of Arrangement

In a creditor scheme, the company is often controlled by a provisional liquidator but the court may permit a continuing role for the directors under the supervision of the provisional liquidators.

In a creditor scheme, the terms of the proposed scheme will determine the position of employees, if the scheme needs to do so. The particular terms of a creditor scheme are likely to determine the effect of contracts, if any.

CLAIMS

Secured creditors are entitled to recover their entitlements through enforcement of their security without reference to the company's general body of creditors. There is no moratorium on a secured creditor's enforcement rights in the Cayman Islands by reason of any insolvency process.

In a company's liquidation, unsecured creditors (or secured creditors to the extent their claim is unsecured) lodge a proof of debt for the amount of their claim. If that proof of debt is rejected by the liquidator, creditors have 21 days within which to appeal to the Grand Court against that rejection.

The costs of winding up (including the costs incurred by the petitioner who successfully sees a winding up order) are paid from the assets of the company in priority to all other claims. Preferential payments are made in respect of employees' wages and other benefits, certain debts due to bank depositors and sums due to the Cayman Islands Government for import duty, stamp duty, licence fees and other statutory taxes.

After preferential payments are made, the company's remaining creditors are paid on a pari passu basis (subject to subordination and set-off adjustments) and any surplus is returned to shareholders. Post-liquidation interest may be paid to creditors, in priority to shareholder claims, after all debts proved in the liquidation are paid. Interest is paid at either a prescribed rate or the applicable contractual rate, whichever is higher.

In a scheme of arrangement, creditors prove their debts for voting purposes and participate in the scheme in accordance with its terms if it is approved by the requisite majority of creditors and the Court. The only changes in priority of claims in a scheme of arrangement are those imposed by the terms of the scheme itself.

CROSS-BORDER INSOLVENCY

Part XVII of the Companies Law codifies the Grand Court's powers to make orders in aid of foreign insolvency proceedings. These powers continue the historical approach of the Cayman Islands based on comity. They follow many of the principles enshrined in the UNCITRAL Model Law on Cross-Border Insolvency, but stop short of implementing it.

In particular, in the Cayman Islands there are no threshold tests for the grant of assistance, or automatic rights based on the centre of main interests (COMI) of the debtor. However, the same types of relief and assistance as are available in the United States, for instance, may be granted in the Cayman Islands at the discretion of the Grand Court Judge hearing the matter. Foreign representatives must satisfy the Cayman Court that it is appropriate for the Court to exercise its discretion by granting the relief sought in the foreign representative's application. The central issue under Part XVII is therefore the appropriateness of the Cayman Court granting the relief sought, not the question of where the debtor's COMI is located.

Where the Court chooses to exercise its discretion the forms of ancillary relief that the court can provide to foreign representatives are (a) recognition (giving power to act on behalf of the debtor in the Cayman Islands) (b) enjoining the commencement or staying the continuation of legal proceedings against a debtor (c) staying the enforcement of any judgment against a debtor (d) requiring a person in possession of relevant information to be examined and produce documents, and (e) ordering the delivery up to a foreign representative of any property belonging to a debtor.

In any case where a company in liquidation or its assets are subject to bankruptcy proceedings in another jurisdiction, the Cayman liquidator is required to consider whether it would be appropriate to enter into a protocol with any relevant foreign office-holder.

ALTERNATIVE RELIEF

Although receivership is not part of the formal insolvency regime of the Cayman Islands, as a matter of practice it may offer an alternative and receivership appointments do occur in a variety of circumstances. Receivers are commonly appointed without any court involvement pursuant to rights in a security instrument, but can also be appointed by the court in aid of equitable enforcement of judgments, or where there is a threat to trust property and in other cases where the Cayman Court is persuaded that it is appropriate for it to exercise its discretion to make such an appointment.

INSOLVENCY PRACTITIONERS

As part of the changes introduced in 2009, the Insolvency Practitioners Regulations govern who may be appointed as an official liquidator. The regulations lay down requirements as to professional qualifications, independence, the maintenance of professional indemnity insurance and residence. A foreign practitioner who meets the independence and insurance requirements may be appointed jointly with an eligible Cayman practitioner, but cannot be a sole liquidator.

The Regulations also govern the remuneration of official liquidators and the manner in which it is approved.

For more specific advice on Insolvency in the Cayman Islands, we invite you to contact:

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