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China Shansui Cement Group Limited: Cement Shoes for Directors?

In 2011, in the case of *Re China Milk Products Group Limited* Mr Justice Jones held that the directors of an insolvent company had inherent authority to petition for its winding up, even if they are not empowered to do so by the company's articles. Whilst this was a pragmatic interpretation of Cayman Islands law that resulted in the logical commercial outcome in that particular case (in which there was no shareholder opposition), the ruling in *China Milk* was criticised for giving directors a wider discretion than was intended by the legislation. In a carefully considered judgment handed down on 25 November 2015, Mrs Justice Mangatal disagreed with Mr Justice Jones's construction of the statutory provisions and struck out a winding up petition brought by the directors of an insolvent company who did not have the requisite authority from the shareholders to petition for the company's winding up.

The decision, as has been widely anticipated would occur in an appropriate case, has removed the ability of directors to unilaterally petition for the winding up of an insolvent company in circumstances where the shareholders do not support their proposal. This absence of this alternative will inevitably cause difficulty for directors' who owe fiduciary duties to the company, and must take into account the needs of creditors in considering these duties, when the company enters the "zone of insolvency". Directors may then be left in the difficult position of being forced to resign rather than carry on as stewards of an insolvent company without the power to petition the Court to place the company in liquidation. The legislative intent of the relevant Companies Law provision in the Cayman Islands is to permit a winding up of insolvent companies by creditors. This decision highlights that the law as drafted prevents the directors from acting directly in the interests of creditors when the shareholders are apathetic or act in their own self-interests and highlights the need for consideration of further legislative reform.

Directors' Powers Before *China Milk*

Section 94(1) of the Companies Law provides for the categories of persons that may present a petition for winding up by the Court: (a) the company; (b) creditors; (c) contributories; or (d) the Cayman Islands Monetary Authority.

Section 94(2) provides that "Where expressly provided for in the articles of association of a company the directors of a company incorporated after the commencement of this Law have the authority to present a winding up petition on its behalf without the sanction of a resolution passed at a general meeting."

Before *China Milk* the practice was that whilst directors could make a recommendation to shareholders that the company should petition for its winding up, they could not implement this without shareholder approval, unless there were express terms in the articles permitting them to do so.

This principle stemmed from the English case of *Re Emmadart*, in which Brightman J (as he then was) considered the equivalent provision in the English Companies Act 1948. Having conducted an extensive review of the English and Commonwealth cases, Brightman J determined that the directors acted as agent of the company and needed to have authority conferred on them either by the articles of association or by the shareholders in general meeting. He therefore concluded that "the practice which seems to have grown up, under which a board of directors of an insolvent company presents a petition in the name of the company where this seems to the board to be the sensible course, but without reference to the shareholders, is in my opinion wrong and ought no longer to be pursued, unless the articles confer the requisite authority".

Emmadart was applied in the Cayman Islands in the decision of Mr Justice Smellie (as he then was) in *Banco Economico SA v Allied Leasing and Finance Corporation.*

The Decision in *China Milk*

In *China Milk*, Jones J was considering a petition for the winding up of China Milk Products (**China Milk**), an insolvent company, by its directors with the aim of appointing provisional liquidators to effect a scheme of arrangement (the common method for restructuring of debts in the Cayman Islands in the absence of a provision similar to the Administration process in England & Wales or Chapter 11 of the US Bankruptcy Code), supported by the majority of China Milk's bondholders. China Milk's shares were listed on the Singapore Stock Exchange. There appears to have been no attempt in that case to seek the approval of the shareholders for the restructuring, but given the financial circumstances of China Milk those shares had no real economic value. In any event, the shareholders did not seek to challenge the petition, the issue only being argued before his Lordship because of his concerns to hear argument about whether the directors had power to present a winding up petition without a shareholder resolution.

In reaching his decision, Jones J concluded that Smellie J had reached the conclusion that *Re Emmadart* applied in the Cayman Islands "somewhat reluctantly" and went on to consider the section in the light of the substantial amendments to the Cayman Islands Companies Law from 2007-2009, resulting in the 2009 Revision of the Companies Law.

Jones J had been involved in the review leading to those amendments and spoke with first-hand knowledge about the considerations, indicating that the rule in *Emmadart* had been considered and the Legislature must have intended to abolish or circumscribe the rule because it did not distinguish appropriately between solvent and insolvent companies. Although this distinction did not actually appear in the subsequent legislative drafting Jones J determined that the directors of an insolvent company incorporated after 1 March 2009 (the implementation of the amendments) were entitled to present a winding up petition on behalf of and in the name of the company without reference to the shareholders and irrespective of the terms of the articles of association.

This meant that there was a difference of approach to be taken between solvent or insolvent Cayman Islands companies incorporated after 1 March 2009. If a company was solvent, a resolution was required, if it was insolvent, a resolution was not required, unless the articles expressly reserved this power to the shareholders. In doing so, Jones J noted that the position in England was subsequently changed by the Insolvency Act 1986, section 124(1), which empowered the directors to present a petition on grounds of insolvency in their own right, which was simply another way of achieving his interpretation.

There was no objection from the shareholders, who had no economic interest in the present case.

China Cement

Mangatal J was faced with a similar petition for the winding up of *China Shanshui Cement Group Limited* (**China Cement**), in conjunction with an application for the appointment of provisional liquidators to effect a restructuring of the debts of *China Cement*. China Cement's principal creditors supported the restructuring, whilst the shareholders did not, arguing that China Cement was balance sheet solvent. The directors petitioned for the winding up of *China Cement* on the just and equitable ground, for the purpose of appointing provisional liquidators, without the support of the shareholders. The articles contained no express authorisation for the directors to petition for China Cement's winding up.

Counsel for the shareholders applied to strike out the application on the basis that the petition was brought without sufficient standing by the board, referring back to the principles in *Emmadar*t that the directors did not have the requisite authority to petition, submitting that *China Milk* had been wrongly decided. The shareholders argued that even if *China Milk* was correct, Jones J's logic could not apply where a company is balance sheet solvent, but suffering cash flow difficulties.

Counsel for *China Cement* argued that *China Milk* was a definitive statement of the law by an experienced Judge of the Grand Court with an unmatched knowledge of the topic. *China Cement* argued that *Emmadart* had only been applied before the major reform to the Cayman Islands Companies law and that *China Milk* had since become settled law. However, counsel could point the judge to no cases where other Grand Court Judges had followed the *China Milk* interpretation. In the absence of such authority, Mangatal J made reference to an article written by counsel for *China Cement* which questioned whether *China Milk* had been correctly decided

and whether it would be followed in a future contested proceeding. It is unclear whether the article was put to the counsel for *China Cement*, but it was clear that the article undermined the bald assertion that *China Milk* was settled law.

Mangatal J was clearly reluctant to undermine judicial comity and certainty. However, she was cognisant that if she was convinced the decision was wrong, she could not shy away from not following it. She noted that although extensive submissions were made in *China Milk*, there was no party before the Court contending for an opposite conclusion and so the decision was not one arrived at after an opposed argument or application. Whilst accepting that Jones J was entitled to consider the legislative intention of the 2009 Revision, she noted that a difficulty of his application was that a materially similar section was in place prior to the amendments, when it was decided in *Banco Economico* that *Emmadart* applied in the Cayman Islands. Mangatal J indicated that there was nothing in the face of the section to support Jones J's distinction between solvent and insolvent companies and there was no change in wording of sub-section 94(1)(a) to give effect to the legislative intent referred to by Jones J. Mangatal J noted there appeared no reason to assume that the lack of substantive amendment to the section was not a deliberate decision on the part of the Legislature not to adopt the course indicated by Jones J – section 94(2) merely confirms that *Emmadart* provision.

Mangatal J disagreed that the restrictive interpretation of the section, giving effect to *Emmadart*, was not "unworkable or impractical" as suggested by Jones J, and that the interpretation had been working previously, even if there were parties who did not like those results or considered them impracticable. In Mangatal J's view the statutory provision contained no ambiguity and therefore, she reluctantly concluded that Jones J's construction of the statutory provisions was wrong, and that she was obliged to differ from them.

Mangatal J noted that *Emmadart* had been a "remarkably unpopular decision" but declined to enter the debate because in her view, the 2007-2009 reforms in the Cayman Islands left the ruling in *Emmadart* intact, particularly as the similar wording of the Law that existed in earlier jurisdictions had been considered in *Banco Economico.* She concluded that it would be wrong of her, as a Judge, to sweep that legislative decision away and that Jones J's description of the contrary arguments in favour of *Emmadart* left the Legislature with a decision and that the statutory provisions as they do in fact exist, left her with the ruling that *China Cement* had no authority or standing to present the winding up petition.

On a side note, given the directors lacked standing, *China Cement* asked Mangatal J to consider substituting a creditor to its petition. Mangatal J considered that the Companies Winding Up Rules only permitted a creditor to creditor substitution, not the substitution of a creditor for *China Cement.*

Conclusion

In the zone of insolvency, the wishes of shareholders will most often be at odds with the interests of creditors. The *Emmadart* rule, which Mangatal J considers still applies pursuant to section 94, restricts the directors' ability to seek the winding up of a company, effectively giving the shareholders a veto, despite the shareholders potentially having no realisable economic interest, due to the paramountcy of creditors.

This is the plain English interpretation of section 94 – the section itself makes no distinction between solvent and insolvent companies. As Mangatal J recognised, judicial restraint is required where a section is unambiguous even where the result is considered undesirable or impractical by some parties, otherwise the judges begin to infringe on the constitutional separation of powers.

However, the general scheme of the winding up provisions is to protect creditors when a company becomes insolvent. A shareholder veto on the directors' action contradicts this principle, fettering the directors' ability to act in the interests of the creditors at the crucial point in time, leaving a director in a difficult position with respect to his fiduciary duties and perhaps with no option but to resign. Although the ruling of Jones J in *China Milk* is a pragmatic judgment that is consistent with this overall scheme, permitting the directors to act as they consider appropriately, the *China Cement* decision is a clear indication that the plain English reading of the provision will be preferred, despite the arguably anomalous result. Clearly there is a case for legislative reform in this area, but for now the plain English reading of section 94(1) prevails, with the consequence that the law in the Cayman Islands is consistent with the *Emmadart* rule.

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