APPLEBY

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In the matter of the SPhinX Group of Companies

The impact of arbitration clauses on corporate insolvency litigation is still being worked out in the offshore world. In the insolvency sphere there is a tension between, on the one hand, the bi-lateral resolution of private disputes for which arbitration clauses have been crafted and, on the other hand, the statutory insolvency regime, according to which proceedings to wind up a company are a class action brought in the public interest for the purpose of realising and distributing the assets of a company for the benefit of its creditors.

What is to be done when insolvency litigation throws up a dispute that is also the subject of an arbitration clause? The arbitration clause is a binding contractual term under which the dispute is to be resolved under the bi-lateral private regime. Must it yield its power to require arbitration when the dispute also engages the public interest and arises in the context of the class action? The Court of Appeal of England and Wales (*Salford Estates (No.2) Limited v. Altomart Limited* [2015] Ch. 589) held in late 2014 that the answer to this question is a qualified "no" - unless there are exceptional circumstances the dispute must be resolved by arbitration.

In December 2015 the Eastern Caribbean Court of Appeal (sitting in the BVI) refused to follow the *Salford Estates* approach (*Jinpeng Group Ltd v Peak Hotels and Resorts Limited* (BVIHCMAP 2014_0025 and 2015_0003)). Now the Court of Appeal of the Cayman Islands has pronounced on the subject (*in the matter of the SPhinX Group of Companies* CICA 6/2015*).* In *SPhinX* the *Salford Estates* reasoning was indorsed and applied.

The impact of arbitration clauses in insolvency litigation

In *Salford Estates* the issue arose in the context of provisions of the Insolvency Act 1986 that empower the court to wind a company up where it is unable to pay its debts as they fall due. Under English, Cayman Islands and BVI law this is a classic case of commercial insolvency that will justify putting the company into liquidation. Petitions to wind up a company can be based on the non-payment of a single debt. Where the debt is disputed on substantial grounds the petition will be dismissed, because a company that is not paying a claimed debt because it disputes the debt on substantial grounds is clearly not by virtue of that simple fact evidencing that it is insolvent. Where, however, the debt is admitted or is disputed, but without there being any substance in the objection to pay, the company is normally treated in all three jurisdictions as evidencing insolvency justifying an order to wind up. It is thus common to see petitions to wind up a company turning into contests over whether there are substantial grounds for disputing the debt on which the petition is founded.

Where the debt is alleged to arise under a transaction governed by an arbitration clause there is a difficulty. The difficulty arises because under English, Cayman and BVI law if a dispute falls within an arbitration clause and one of the parties brings a claim in court, the other party is entitled to a mandatory stay of the court proceedings in favour of the dispute being resolved by arbitration, unless the arbitration clause is "null and void, inoperative or incapable of being performed". It has been established that for the purposes of this rule a dispute means any dispute, even one that has little substance. What that means is that a party with the benefit of an arbitration clause by merely stating that it disputes the liability is able to cause a stay of court proceedings in favour of arbitration.

In *Salford Estates* the Court of Appeal in England and Wales had to consider whether a petition to wind up a company for non-payment of a debt was subject to the mandatory stay. The Court of Appeal analysed winding up proceedings as actions brought in the public interest for the benefit of a class (the creditors of the company as a whole) whose purpose was to trigger a statutory scheme for the realisation and distribution of the company's assets. On this basis the Court of Appeal held that winding up petitions do *not* fall within the statutory provisions mandating a stay in favour of arbitration. At first sight this looks like a blow to the primacy of the arbitration clause; but this was not the end of the story.

The court's power to make a winding up order is itself discretionary. The existence of an unpaid debt is a necessary but not sufficient condition for making an order. The Court of Appeal in *Salford Estates* went on to decide that where a debt is disputed and subject to an arbitration clause the court dealing with the petition should normally exercise its discretion to stay or dismiss the petition in order to compel the parties to resolve the dispute by arbitration. The Court of Appeal held that any other disposal would require "exceptional circumstances" – so exceptional that the Court was unable to envisage what those circumstances might be.

In *Jinpeng* the Eastern Caribbean Court of Appeal agreed with the court in *Salford Estates* that a petition to wind up did not itself fall within the statutory provisions requiring a stay where there is an arbitration clause. However, it refused to accept that the policy behind those provisions required the court nevertheless to order a stay unless there were exceptional circumstances.

SPhinX involved an agreement between SPhinX's liquidators and Beus Gilbert PLLC (**BG**) for legal representation (the **LRA**) under which BG was to be remunerated on a contingency fee basis. The LRA contained an arbitration clause. At the time of the applications in *SPhinX* the liquidators were holding a reserve of US$50 million against potential liabilities to BG under the LRA. The applications in *SPhinX* were brought to compel the liquidators to release the reserve. The argument for releasing the reserve was that nothing was owed under the LRA – BG's claims were "fanciful", so that the liquidators were not justified in holding on to the reserve.

The applications proceeded on the basis that the application to force the release of the reserve was a legal proceeding within the mandatory stay provisions of the Cayman Islands statute, but it was argued that the fixing of a reserve by a liquidator pursuant to this statutory duty and under the supervision of the court is by its very nature incapable of being arbitrable under an arbitration agreement. It was not the function of an arbitral tribunal to determine what reserves, if any, a liquidator should make. Rather, the function of such a tribunal was to determine the legal outcome of disputes between the parties to the arbitration agreement in question. Accordingly, it was legally impossible to delegate to an arbitrator the question of fixing a reserve. A liquidator can no more contract out of the control of the court than a company can contract out of the statutory scheme that governs it.

The judge at first instance and the Court of Appeal both considered that the question whether the reserve should be released was wholly dependent upon the question whether SPhinX was liable for the fees. Adopting the reasoning in *Salford Estates* they both concluded a stay was required in order to avoid the arbitration clause being by-passed.

The Cayman Islands Court of Appeal commented that it was obvious that BG's fee claims were disputed by the liquidators and that the dispute fell within the fee arbitration clause in the LRA. The fact that neither party had activated the arbitration process was no bar to a stay. The question whether the claims are fanciful so that the US$50 million reserve could be released depended entirely on whether those claims were bad in law; an issue squarely within the LRA. The dispute was about fees first and then only about reserves - the latter question being wholly dependent on the answer to the first. The Court of Appeal made an order deferring the applications to release the reserve until after arbitration had taken place to determine whether there was a liability in the first place.

Having vindicated the primacy of the arbitration clause, the Court of Appeal went on to a comment on a further submission by the liquidators' counsel regarding a Cayman first instance decision in *Re Cybernaut Growth Fund* 2014 (2) CILR 413 in which the judge had refused to allow a dispute over the identity of a liquidator to be referred to arbitration, notwithstanding the presence of an arbitration clause apparently covering that very question. The judge's reasoning was that the dispute was non arbitrable and that the public interest was engaged so that the court had exclusive jurisdiction of the question. The Court of Appeal in *SPhinX* held that this reasoning was "debatable".

Conclusion

The impact of arbitration clauses on insolvency litigation now appears to depend on where you are litigating. The policy underlying statutes according primacy to arbitration clauses in England and Wales, the Cayman Islands and the BVI is the same. The rule that a company may be wound up for failure to pay a debt when it falls due is the same in all three jurisdictions. It is paradoxical that the same facts will give different results in jurisdictions that use the same rules and give effect to the same policies.

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