

Legal Briefings

Insolvency in the Cayman Islands – setting aside antecedent transactions.

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In certain circumstances the official liquidator of a Cayman company may be able to take action to recover assets which have been transferred in the run up to the company's insolvency. It is important for those concerned with the affairs of a Cayman company in the twilight of insolvency to be aware of the statutory powers available to the official liquidator and the Grand Court in the Cayman Islands.

Summary

This Briefing sets out, among other things, the following positions under Cayman law with respect to matters to consider when a Cayman company faces liquidity issues and financial difficulties which might lead to the relevant entity's insolvency:

- i. The liquidator of a Cayman company can apply to the Court to set aside a transaction of the company in favour of any creditor, at a time when the company is unable to pay its debts, where such transaction was entered into with a view to giving such creditor a preference over other creditors, if such transaction was made, incurred, taken within six (6) months immediately preceding the commencement of a liquidation of the company.
- ii. The Directors of a Cayman company, the General Partner of an ELP and the Manager of an LLC should exercise caution and seek legal advice from Cayman legal counsel where there is any uncertainty about the solvency (on a cashflow basis) of the applicable Cayman entity which they are managing. These situations might, for example, arise within the context of an investment fund with severe liquidity issues.
- iii. Every disposition of property made at an undervalue by or on behalf of a Cayman company with intent to defraud its creditors is voidable at the instance of its official liquidator.
- iv. If in the course of the winding up of a Cayman company it appears that any business of the company has been carried on with intent to defraud creditors of the company or

creditors of any other person or for any fraudulent purpose, the liquidator may apply to the Court for a declaration that any persons who were knowingly parties to the carrying on of the business with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose are liable to make such contributions, if any, to the company's assets as the Court thinks proper.

- v. When Directors of a Cayman company are considering their fiduciary duties, the weight to be given to the interests of creditors will increase as the company's financial difficulties become increasingly serious. Creditors' interests will take precedence over the interests of the company's shareholders at the point where insolvent liquidation or administration is inevitable.

Voidable preferences

The Companies Act (As Revised) of the Cayman Islands (the "**Act**") provides that "[e]very 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 voidable upon the application of the company's liquidator if made, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation."

It is important to note that a payment to a "*related party*" of the Cayman company shall be deemed to have been made with a view to giving a creditor a "*preference*" and therefore would be voidable upon the application of the company's liquidator if made, incurred, taken or suffered within six (6) months immediately preceding the commencement of a liquidation.

A creditor is treated as a "*related party*" if it has the ability to control the Cayman company or exercises significant influence over the company in making financial and operating decisions.

When is a company unable to pay its debts?

A Cayman company is deemed to be unable to pay its debts if:

- (a) it fails to comply with a statutory demand;
- (b) the company fails to satisfy a judgment debt; or
- (c) it is proven to the satisfaction of the Court that the company is unable to pay its debts.

Commencement of a liquidation

Under Cayman law, the compulsory winding up of a company is deemed to commence at the time of the presentation of the petition for the winding up or, in the case of a voluntary liquidation, at the time of the resolution or expiry of the relevant period, or occurrence of an event provided by the company's Articles of Association upon which the company is to be wound up, or in the case

where a restructuring officer has been appointed pursuant to section 91B or 91C of the Act and the order appointing the restructuring officer has not been discharged, at the relevant time on the date of the presentation of the petition to appoint a restructuring officer pursuant to section 91B of the Act.

Dispositions at an Undervalue

Every disposition of property made at an undervalue by or on behalf of a company with intent to defraud its creditors shall be voidable at the instance of its official liquidator (i.e. the liquidator of a Cayman company which is being wound up by order of the court or under the supervision of the court and includes a provisional liquidator). The official liquidator bears the burden of establishing an “intent to defraud” (i.e. the official liquidator must establish that there was an intention to wilfully defeat an obligation owed to a creditor). The intention to defeat a creditor needs only be “a” purpose and not the sole or dominant purpose. No legal proceedings may be brought by the official liquidator under after six (6) years following the date of the relevant disposition or transaction.

The term “*undervalue*” in relation to a disposition of a company’s property means (i) the provision of no consideration for the disposition; or (ii) a consideration for the disposition the value of which in money or money’s worth is significantly less than the value of the property which is the subject of the disposition.

However, the rights of the transferee of such property are subject to some protection. In the event that any disposition is set aside and the Court is subsequently satisfied that the transferee has not acted in bad faith: (i) the transferee will have a first and paramount charge over the property which is the subject of the disposition, of an amount equal to the entire costs properly incurred by the transferee in the defence of the action or proceedings; and (ii) the relevant disposition will be set aside subject to the proper fees, costs, pre-existing rights, claims and interests of the transferee (and of any predecessor transferee who has not acted in bad faith).

Fraudulent Trading and Liability to Contribute

If in the course of the winding up of a Cayman company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the liquidator (i.e. official liquidator or voluntary liquidator) may apply to the Court for a declaration that any persons who were knowingly parties to the carrying on of the business with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose are liable to make such contributions, if any, to the company’s assets as the Court thinks proper. Directors of a Cayman company will face the real risk of liability when managing a company’s business if that business is carried on fraudulently. Unlike dispositions at an undervalue, there is no applicable limitation period for fraudulent trading.

Fiduciary Duties of Directors of Companies facing Insolvency

In addition to Cayman companies, Cayman Islands law as stated above may also apply to limited liability companies (LLCs) and exempted limited partnerships (ELPs). Accordingly, the Directors of a Cayman company, the General Partner of an ELP and the Manager of an LLC should exercise caution and seek legal advice from Cayman legal counsel where there is any uncertainty about the solvency (on a cashflow basis) of the applicable Cayman entity which they are managing. These situations might, for example, arise within the context of an investment fund with severe liquidity issues. Directors should consider carefully the point at which creditors' interests take priority over shareholders' interests and how those interests are best served (e.g. appointment of a liquidator or a restructuring officer). Failure to seek urgent advice on their duties could increase the Directors' exposure to risk of personal liability.

The fiduciary duty of directors is to act in good faith in the interests of a Cayman company. The interests of the company have until recent times been treated as being the interests of its members as a whole. However, in the UK Supreme Court's decision given on 5 October 2022 in BTI 2014 LLC (Appellant) v Sequana SA and others (Respondents), which is persuasive authority in the Cayman Islands, it was re-affirmed that directors of financially distressed companies are required to consider, as one of the relevant factors, the interests of creditors. The Supreme Court concluded that the weight to be given to the interests of creditors will increase as the company's financial difficulties become increasingly serious. Creditors' interests will take precedence over the interests of the company's shareholders at the point where insolvent liquidation or administration is inevitable.

Transactions which are void ab initio

Official liquidation

When a winding up order has been made, any disposition of the company's property and any transfer of shares or alteration in the status of the company's members made after the commencement of the winding up is, unless the Court otherwise orders, void.

The commencement of a winding-up is the date a petition is presented to the Court (or, if the company was first placed into voluntary liquidation, the passing of that resolution) rather than the date when the Court grants a winding-up order. Accordingly, any transaction during the period between the presentation of a winding-up petition and its resolution before the Court, will be avoided if a winding-up order is ultimately granted, unless the Court validates the transaction.

The presentation of a winding-up petition can have a material adverse effect on a company's business, due to the uncertainty during the period between the presentation of a winding-up petition and its resolution before the Court. A validation order takes away that uncertainty and enables companies to continue to operate in the ordinary course of their business prior to the hearing of the petition.

Voluntary liquidation

Any transfer of shares, not being a transfer with the sanction of the liquidator, and any alteration in the status of the company's members made after the commencement of a voluntary winding up is void. Unlike a compulsory liquidation, a transfer of the company's property is not automatically void. There is not normally the same uncertainty with voluntary liquidations because upon the appointment of a voluntary liquidator, all of the powers of the directors cease and are displaced by the voluntary liquidator (except so far as the company in a general meeting or the voluntary liquidator sanctions their continuance). Accordingly, the transfer of property is not automatically void but any transfer of property effected by the company after the appointment of a voluntary liquidator should be authorized by the liquidator.

Further Assistance

This Briefing Note is not intended to be a substitute for specific legal advice or a legal opinion. For more specific advice on setting aside of antecedent transactions in the Cayman Islands, please contact any of:

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