REPORT OF THE LAW REFORM COMMISSION

REVIEW OF THE CORPORATE INSOLVENCY LAW AND RECOMMENDATIONS FOR THE AMENDMENT OF PART V OF THE COMPANIES LAW

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1. Introduction

1.1 In 2002 the Financial Services Secretariat asked Andrew J. Jones QC and G. James Cleaver to prepare a report upon the insolvency law and practice in response to the points made by KPMG in its *Review of Financial Regulation in the Caribbean Overseas Territories and Bermuda*. In the event it was decided to deal with the matter in two stages. Messrs Jones and Cleaver submitted a report dated 29 May 2002 dealing solely with cross-border insolvency issues and the extent to which Cayman Islands law and practice is consistent with the Uncitral model law.[1] A copy of this report is attached. It was recognised that in order to conduct an in depth review of the insolvency law and practice as a whole, a larger and more broadly based committee should be established. In the event the subject was divided into a series of discreet topics which were considered by seven separate groups whose reports were all submitted to Andrew Jones who acted as the overall chairman. A substantial amount of detailed work has been done by this private sector committee over the past three years.

1.2 The Law Reform Commission decided that it should assume responsibility for reviewing this important area of the law and therefore asked the private sector committee to submit its report and recommendations, which was done in September 2005. Our report is therefore based to a substantial extent upon the research and recommendations of a broadly based private sector committee comprising insolvency practitioners and lawyers involved with capital markets and asset finance business. However, the Commission has in addition carried out its own consultation process and received input from the Monetary Authority and various private sector bodies which had not been represented on the original private sector review committee.

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[1] The United Nations Commission on International Trade Law (generally known as "Uncitral") published a model law on cross-border insolvency in 1997.

2. Executive summary

- The existing law suffers from being unduly complex because it is derived from a combination of 19th century legislation, inappropriate foreign rules and local case law.
- The Commission therefore recommends that the existing law and best practice be codified by re-writing Part V of the Companies Law.
- The practice of attempting to apply foreign insolvency rules does not work satisfactorily.
- The Commission therefore recommends the establishment of a new Insolvency Rules Committee which will be charged with the responsibility of enacting insolvency rules which specifically meet the needs of the Cayman Islands financial services industry.
- In order to avoid damaging the Cayman Islands capital markets and asset finance business, it is critically important to maintain our current status as a 'creditor friendly jurisdiction'.
- The Commission therefore recommends that "corporate rescue" provisions similar to Chapter 11 of the US Bankruptcy Code should not be introduced into the law.
- It is the practice of the Grand Court to appoint as official liquidators only professional insolvency practitioners.
- The Commission recommends that the Insolvency Rules Committee be empowered to make regulations relating to the qualification and disqualification of professional insolvency practitioners.
- There is currently a considerable degree of cross-border co-operation in respect of insolvency matters, but the basis upon which this co-operation is afforded depends largely upon judicial practice.
- The Commission therefore recommends that the law relating to international co-operation in respect of insolvency matters be codified and included in a new Part XVI of the Companies Law.

3. The Cayman Islands status as a creditor friendly jurisdiction

3.1 The insolvency law regulates the relationship between the debtor, his creditors and society as a whole. In many countries the insolvency law focuses upon society and is designed to prevent unemployment. The interests of creditors, in particular banks and other lenders, are often subordinated to the interests of employees through the imposition of a variety of so-called 'corporate rescue' procedures. For example, under Chapter 11 of the United States Bankruptcy Code, the management of a company is able to impose a moratorium upon its creditors whilst it attempts to work out a rescue plan. In many countries the insolvency law gives local creditors preferential treatment at the expense of foreigners.

3.2 In contrast, Cayman Islands insolvency law focuses upon the rights of creditors as a result of which a huge volume of capital markets and asset finance business is placed through Cayman Islands incorporated companies. In order to avoid damaging this important area of business it is critical that the following characteristics are preserved and, where appropriate, re-confirmed in the form of black letter law.

- There will be no corporate rescue provisions which enable management to impose a moratorium upon creditors but remain in control of the company.
- All creditors are treated equally, irrespective of their nationality.
- The law will reconfirm that creditors may enforce their security without reference to a liquidator.
- The definition of insolvency is reconfirmed and clarified by including both a cash-flow test and balance sheet test.
- The collective right of creditors to select their own liquidator is established.
- Liquidators’ reporting obligations will be clarified in the supporting Rules.
- Existing rules relating to preference payments are re-stated.
- The rules relating to the avoidance of pre-liquidation transactions are clarified.

3.3 The Commission considered whether the Law should include provisions, referred to as a *company voluntary arrangement,* the effect of which would be that creditors' rights can be varied by means of a resolution approved by a majority of 75% of creditors by value. Some insolvency practitioners proposed that provisions substantially the same as those originally contained in Part I of the English Insolvency Act 1986 should be added into Part IV of the existing law. This proposal was controversial for two reasons. First, the general view of capital markets lawyers is that such provisions would detract from the jurisdiction's creditor friendly status and could be a deterrent to business notwithstanding an express statement that the rights of secured creditors would be unaffected. Second, some insolvency practitioners point to the fact that this form of company voluntary arrangement was relatively little used in England with the result that the original English legislation was substantially amended in 2000 and they contend that it is unlikely to serve any useful purpose in Cayman.[2] On balance, the Commission concluded that the proposed amendment would detract from the jurisdiction's creditor friendly status without securing any practical benefit. The proposal was therefore rejected.

4. **Codification of the existing law and best practice**

4.1 The existing law is highly complex and in some respects uncertain which means that it can be difficult for transactional lawyers to issue 'clean opinions'.

4.2 The existing law relating to corporate insolvency is derived from three basic sources, namely –

- Part V of the Companies Law.
- The English Insolvency Rules 1986.
- A body of local case law.

4.3 Part V of the Companies Law is a direct reproduction of the English Companies Act 1862. Unlike the rest of the Companies Law, it has not, until now, been the subject of

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[2] See Ian Fletcher's *The Law of Insolvency* (3rd Edition) pages 425-7 for a discussion of the English law and the reasons why it was amended.

any comprehensive review and has been amended in only two respects since it was originally enacted in 1961.[3]

4.4 Section 174 confers a rule making authority on the Court which has never been exercised. The default provision is that the Court should follow the general practice as it existed in Jamaica when the Companies Law was enacted in 1961. This was generally assumed to mean that the Grand Court should apply the English Winding-up Rules 1948 which were then (and indeed still are) applied in Jamaica. However, when these rules were repealed in 1986 there was debate about whether the Grand Court should continue to apply the 1948 Rules or apply the 1986 Rules or apply other rules on a case by case basis.[4] The Grand Court Rules Committee sought to end this debate in 1995 by determining that the English Insolvency Rules 1986 should be applied "so far as practical" and "insofar as such rules are not inconsistent with the Companies Law". In fact, many of these rules cannot be applied either because they are inconsistent with the Law or there is no substantive legal provision to underpin the rule. Consequently, there is a body of local case law which says which of these rules apply and which ones do not. On any view, this arrangement is unsatisfactory and the Commission therefore recommends that a new rule making body, to be called the Insolvency Rules Committee, be established and charged with the responsibility of enacting a comprehensive set of local rules.[5]

5. The distinction between solvent and insolvent liquidations

5.1 The existing law relating to the liquidation of companies does not formally distinguish between those which are solvent and those which are insolvent. In practice this is *the* critical distinction. In practice insolvent companies are usually put into compulsory liquidation by order of the Court or are brought under the supervision of the Court. The result is that the Grand Court normally supervises insolvent liquidations and solvent

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[3] A review conducted in 1990 by David Bird (then a partner of W.S. Walker & Co) and Andrew Jones (a partner of Maples and Calder) under the auspices of the Law Society did not result in any legislative changes because it was never considered by Government.

[4] In at least one case the Grand Court decided to apply the Hong Kong Rules.

[5] The draft bill includes appropriate transitional provisions. It is intended that the statute and the supporting rules will come into force simultaneously. To achieve this result, the sections establishing the Insolvency Rules Committee will be brought into force first. The remaining provisions will be brought into force by order of the Governor in Cabinet when the Insolvency Rules Committee has completed the preparation of the new rules.

liquidations are normally conducted voluntarily without any reference to the Grand Court.

5.2 The Commission recommends that the distinction between solvent and insolvent liquidations should be formally recognised in the legislation. Section 125 of the draft bill provides that whenever a company is being wound up voluntarily its liquidator must apply to bring the liquidation under the supervision of the Court unless its directors have signed a declaration of solvency in the prescribed form. It follows that the voluntary liquidation process will be limited to those companies which are clearly solvent and the Grand Court will be responsible for supervising the liquidators of all insolvent (or doubtfully solvent) companies. This change in the law effectively codifies current best practice.

6. The test for insolvency

6.1 Surprisingly, this fundamental question has been the subject of considerable debate between the insolvency practitioners and certain transactional lawyers. The issue is whether the test for insolvency should be based solely upon a strict "cash flow test" (as it was in England prior to 1907) or whether it should include a "balance sheet test".

6.2 The strict application of the cash flow test contained in the existing law (as interpreted in the pre-1907 English case law) means that if a company is able to pay its *current* debts as they fall due, it may do so even though the amount of its liabilities exceeds the amount of its assets. The Commission believes that the application of this rule alone produces commercially unacceptable results because it prefers today's creditors over tomorrow's and prefers creditors (whose debts are presently due and owing) over claimants. For example, it would mean that an insurance company which has sufficient cash to pay its admitted claims in full, may do so without regard to the interests of policyholders whose claims have not yet been notified or quantified. The Grand Court has not interpreted the existing law in this way and has held that the court should take into account a company's prospective and contingent liabilities in determining whether or not it is insolvent, but in a very recent decision the Court of Appeal felt constrained to apply the pre-1907 case law, thus throwing the need for reform into sharp focus.

6.3 The insolvency practitioners recommend that the existing cash flow test be supplemented with a balance sheet test, to the effect that a company should be deemed to be insolvent if the amount of its liabilities exceeds the amount of its assets, notwithstanding that it may be able to pay its *current* debts as they fall due. This recommendation is consistent with the public policy reflected in the regulatory laws which require that CIMA must apply both a cash flow and a balance sheet test in determining whether licensed banks and insurance companies are solvent. [6] For example, it would be contrary to public policy to allow an insurance company whose liabilities exceed its assets to pay admitted claims in full with the result that its non-admitted claims and future claims (incurred but not yet notified) cannot be paid in full, or even at all. The Commission considers that the application of a strict cash flow test, which does not require that contingent and future liabilities be taken into account, can produce socially and commercially unacceptable results.

6.4 However, during the course of our consultation process it was suggested (by Walkers in particular) that the introduction of a balance sheet test or the amendment of the cash flow test as strictly interpreted in the pre-1907 English case law) might have an adverse effect upon CDO business.[7] This issue has been debated at length in various position papers and at a series of meetings amongst insolvency practitioners and transactional lawyers. It is generally accepted that whatever insolvency test is adopted in the Companies Law, it must apply to all companies for all purposes.[8] However, the Commission cannot

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[6] The effect of Section 8 of the Banks and Trust Companies Law (2003 Revision) and Sections 4 and 7 of the Insurance Law (2004 Revision) is that CIMA is required by to apply a balance sheet test in determining whether or not licensed banks and insurance companies are insolvent.

[7] CDO's (collateralised debt obligations) are securitized interests in pools of assets, usually comprising loans, receivables or debt instruments, which are the domain of institutional investors. The terms of a CDO will be set out in an offering document. Typically, promissory notes (and possibly preference shares) are issued by a company which uses the proceeds to purchase a portfolio of assets usually comprising loans, receivables or other debt instruments. The income generated on the portfolio will be used to pay interest on the notes (and possibly also to pay dividends on preference shares) in accordance with a pre-determined order of priority. Subordinated investors enter into the transaction knowing there is a risk that they will not be repaid and this risk is reflected in their rate of return. As a general rule CDO transactions are required to be "bankruptcy remote" which means that investors contract out their statutory right to present a winding up petition in the event that the company becomes insolvent. This is achieved in two ways. First, the company's obligations are expressed to be "limited recourse", ie limited to the amount of the available assets. Second, investors covenant not to present winding up petitions.

[8] The Commission therefore recommends that sections 34 and 37 of the existing law be amended to bring them into line with the proposed new section 93.

recommend the adoption of a strict cash flow test alone, because it can lead to the result that a company can properly pay current creditors and properly pay dividends or redeem shares (without taking into account contingent and prospective liabilities), notwithstanding that its liabilities exceed its assets.

6.5 The Commission recommends that a company be treated as insolvent if (a) it is unable to pay its debts, including prospective and future liabilities, as they fall due or (b) the amount of its liabilities exceeds the amount of its assets. This combined test would be consistent with that applied in many developed countries, including the United Kingdom, and we do not believe, based upon the views expressed by many transactional lawyers, that its implementation would be detrimental to this country's CDO business in any way. Furthermore, the Commission believes that the attractiveness of this jurisdiction for CDO business will be enhanced by giving statutory recognition to "non-petition covenants" which is done in section 95(2) of the draft bill.

7. The roles of the Grand Court and CIMA

7.1 The Commission recommends that the roles currently performed by the Grand Court and CIMA in relation to the liquidation of companies should remain unchanged.

7.2 The Grand Court's responsibility to supervise official liquidators, who are treated as officers of the court, is re-confirmed.

7.3 CIMA's powers in respect of companies which are licensed to carry on regulated businesses includes the power to present a winding up petition on the grounds that the business is being conducted in a manner detrimental to the public interest. Once a winding up order has been made CIMA's responsibility ceases and the company's official liquidator is supervised by the Grand Court. The current allocation of responsibility between CIMA and the Grand Court has worked satisfactorily and the Commission does not see any need for change.

7.4 However, the Commission does recommend that the existing law be amended so as to make it clear that CIMA has power to present winding-up petitions against unlicensed

entities which appear to be carrying on regulated businesses unlawfully. CIMA supports this proposal.

8. The Role of Creditors and Shareholders

8.1 The liquidation process should be driven by those having an economic interest in its outcome. Section 105 of the draft bill provides that the liquidator nominated by the petitioning creditor (or shareholder) will hold office only on an interim basis. The general body of creditors (or shareholders in the case of solvent companies) are given an opportunity to elect a liquidator of their choice.

8.2 Section 106 of the draft bill provides that there shall be liquidation committees comprising between 3 and 5 creditors (if the company is insolvent) or shareholders (if the company is solvent). By Section 110 the liquidation committee will have power to determine the liquidators' fees.[9] The Third Schedule sets out various powers of liquidators which can be exercised only with the sanction of the liquidation committee (or the Court).

8.3 The purpose of these various provisions is to formally codify current best practice which is not fully reflected in the existing law. It is intended that additional detailed provisions, relating to liquidators' reporting obligations, convening creditor/shareholder meetings etc will be contained in the Rules.

9. Investigation by Official Liquidators

9.1 The investigative powers of official liquidators are clarified and extended.

9.2 Section 101 of the draft bill imposes upon various categories of insider an obligation to prepare or concur with a statement of affairs in the prescribed form. This is a sworn statement relating to a company's assets, liabilities and business activities. Anybody who has been a director or officer of the company or professional service provider to the company or any employee of the company is liable to be required to make a statement of affairs.

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[9] See paragraph 14.3 below.

9.3 Section 103 imposes upon such persons a duty to cooperate with official liquidators who will have power to conduct private examinations. The Commission considers that it is not necessary for these examinations to be conducted in public before a judge.

9.4 A controversial issue is the extent to which official liquidators should have a duty to conduct investigations, when the outcome of those investigations may have little or no benefit to the creditors or shareholders who are forced to pay for them. Section 102 of the draft bill empowers liquidators to conduct investigations but does not impose any duty to do so in every case. Official liquidators are also empowered to assist CIMA and RCIP but they will not have any duty to do so at the company's expense without either the consent of the stakeholders or a direction of the Court which will only be made after having heard representations from the stakeholders.

10. Provisional Liquidation

10.1 The Commission considers that the current practice relating to the appointment of provisional liquidators is unsatisfactory and has sometimes been abused.

10.2 Section 104 of the draft bill amends the existing law by setting out two circumstances in which liquidators may be appointed provisionally.

10.3 First, a creditor or contributory may apply to the Court for a provisional order on the grounds that there is a prima facie case for making a winding-up order and that the appointment of a provisional liquidator is necessary to prevent the dissipation or misuse of a company's assets; or prevent the oppression of minority shareholders; or prevent mismanagement or misconduct on the part of the company's directors.[10] CIMA is given the same right to apply for a provisional appointment in any case in which it presents a petition against a company which is carrying on a regulated business.

10.4 Second, applications may be made by the company itself on the ground that it is or is likely to become unable to pay its debts and that it intends to present a compromise or arrangement to its creditors. This form of order has been made successfully in the past

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[10] The proposed amendment of section 96 of the existing law will permit a prospective or contingent creditor to present a winding up petition and apply for the appointment of provisional liquidators, thus reversing the decision in the Indies Suites case in which the Court of Appeal felt compelled to set aside the Grand Court's appointment of a provisional liquidator on the basis of pre-1907 English case law.

and the Commission recommends that the existing law be amended in order to confirm the Court's jurisdiction.

11. **Avoidance of pre-liquidation transactions**

11.1 The Fraudulent Dispositions Law (now re-enacted as Part VI of The Trust Law) provides a remedy for the creditors of companies whose assets have been improperly disposed of at an undervalue. However, the effectiveness of the remedy is limited by the fact that the liquidator of a company does not fall within the definition of 'creditor'. The overall effect of Sections 147 and 148 of the draft bill is to put the liquidator in the same position as the creditors. In future it will normally be the liquidator, rather than a creditor, who will institute proceedings to set aside transactions made at an undervalue.

11.2 Section 146 of the draft bill restates the voidable preference rules without any complicated cross-reference to the Bankruptcy Law. The critical questions in determining whether a payment by a debtor to a creditor constitutes a voidable preference will continue to be whether the debtor made the payment with the dominant intention of preferring the creditors.

12. **Set-off**

12.1 In the case of companies which are clearly solvent, the effect of contractual and procedural rights of set-off are unimportant because creditors can expect to be paid in full in any event. However, set-off rules applicable on insolvency are critically important because those creditors who are able to exercise rights of set-off may recover their debts in full whereas others may receive only cents in the dollar. The only substantive amendment of Part V of the Companies Law made since 1961 concerns the rules relating to set-off and netting. This amendment was made for the purposes of ensuring that the set-off and netting provisions contained in ISDA swap agreements would be enforceable against the liquidators of insolvent Cayman Islands companies. Section 141 (2) of the draft bill reproduces this provision with minor amendments made to clarify that the provision relates to both bilateral and multilateral set-off agreements and to confirm that preferred creditors rank after the application of contractual set-off and netting rights.

13. Insolvency Practitioners: Qualifications

13.1 The majority of liquidations are entirely straightforward because it is clear that the company is solvent with the result that creditors are paid in full in the ordinary course of business, often before the company is put into liquidation. Such liquidations are conducted voluntarily and the shareholders have complete freedom of choice as to the identity of their liquidator. The Commission recommends that the law should continue to permit directors, company administrators and other insiders to perform the role of liquidator in these circumstances.

13.2 However, the Commission also recommends (in section 5 above) that the existing law be amended so as to formally distinguish between liquidation of companies which are solvent and those which are insolvent and that all insolvent liquidations be brought under the supervision of the Court. In keeping with current practice, the Commission recommends that the law be amended to require that all liquidators appointed by the Court must be professional insolvency practitioners.[11] It follows that it becomes necessary to have rules relating to the qualifications and disqualifications applicable to persons who can be appointed as official liquidators. The Commission recommends that the task of formulating these rules be delegated to the Insolvency Rules Committee.

14. Insolvency Practitioners: Powers and Duties

14.1 The Commission recommends that the law relating to the powers and duties of official liquidators be clarified and set out in a new schedule.

14.2 An important aspect of this subject is circumstances in which an official liquidator may exercise his powers with or without the sanction of the Court or the company's stakeholders. The Commission recommends that the law be amended to provide a clear statutory basis for the establishment of liquidation committees comprising creditors (in the case of insolvent companies) or shareholders (in the case of solvent companies).

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[11] In practice the Grand Court has generally followed the old English practice of appointing professional accountants whose firms have had no dealing with the particular company for at least three years immediately preceding the presentation of the petition.

Official liquidators will have a duty to consult with the liquidation committee and the Third Schedule defines the circumstances in which an official liquidator may exercise his powers only with the sanction of the liquidation committee.

14.3 Currently, official liquidators are private practitioners whose remuneration is paid out of the assets of the company, as opposed to public officials paid wholly or partly at Government's expense. No one has suggested that this arrangement be changed. Since the expenses of a liquidation are paid out of the assets of the company at the expense of its creditors, it follows that they should have a role in determining how their money is spent, and in particular how much is paid to its official liquidators by way of remuneration. No one with whom the Commission consulted has questioned the principle that those having an economic interest in the assets of an insolvent company should be entitled to determine how their money is spent. The Commission therefore recommends that liquidation committees should be charged with responsibility for determining the remuneration of liquidators and that the Grand Court should have an appellate jurisdiction in the event that the official liquidator or a significant minority of creditors are dissatisfied with the liquidation committee's determination.

15. Offences of Fraud etc

15.1 Sections 135 to 138 of the draft bill create specific criminal offices in respect of fraudulent actions done in anticipation of an insolvent liquidation or in the course of a liquidation.

15.2 The key features of these offences is that they apply only to a company's "insiders", such as its directors and those professional service providers who control its affairs. Such persons will be guilty of offences only if the relevant actions or omissions were done with the intention of defrauding the company's creditors or shareholders.

16. **Categories of preferred debts**

16.1 The existing law relating to preferred debts is seriously out of date. The Commission recommends that the preferred status of employees, bank depositors and the Government be clarified and re-stated.

16.2 The new Second Schedule does not create any new category of preferred creditors. It is intended to clarify the existing law by removing anomalies and updating the provisions relating to a company's employees.

17. **International Co-operation**

17.1 In their report entitled *Recognition and Cooperation in Cross Border Insolvency Matters* (May 2002) Messrs Cleaver and Jones recommended that the Companies Law be expanded to codify certain matters currently to be found only in the case law.

17.2 It is proposed that the requirement to advertise winding up petitions in foreign publications will be dealt in the Rules. The Court's jurisdiction to appoint "foreign practitioners" (as defined) jointly with qualified insolvency practitioners is confirmed in section 109 of the draft bill. Foreign creditors will have the same rights as local creditors.

17.3 It is recommended that the Grand Court be given power to make ancillary orders upon the application of a trustee, liquidator or other official appointed in respect of foreign companies which are the subject of a bankruptcy/liquidation proceeding in a foreign country. These powers are set out in a proposed new Part XVI of the Companies Law and are based upon the corresponding provisions of the United States Bankruptcy Code with which local insolvency practitioners are very familiar.

17.4 It is not uncommon for a company incorporated under Part II or registered under Part IX of the Companies Law to become the subject of a foreign bankruptcy proceeding. The fact that a company registered under the Companies Law is the subject of a foreign bankruptcy proceeding should be a matter of public record. It is therefore recommended that the new Part XVI include a provision requiring such companies to make a filing with the Registrar of Companies.

18. **Conclusion**

18.1 It has been recognised for many years that it is no longer acceptable for this jurisdiction's corporate insolvency law to be based almost entirely upon the English 1862 Act. The Commission recommends that the Companies Law be amended in the form of the enclosed draft bill. The proposal is that Part V be repealed and replaced; a new Part XVI should be added to deal with international cooperation in cross-border insolvency matters; and certain consequential amendments should be made to others Parts. The rationale for each individual amendment is set out in a very detailed memorandum of objects and reasons.

Nigel Clifford QC

Chairman.

12th April 2006