*The Law Reform Commission*

# REPORT OF THE LAW REFORM COMMISSION

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

**July 2007**
**SUPPLEMENTAL REPORT**

**Final Report No. 3**

**The Law Reform Commission**

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## 1. BACKGROUND

1.1 On April 26, 2006, Nigel Clifford QC, the then chairman of the Law Reform Commission submitted to the Attorney General a report of the Law Reform Commission which was agreed on April 12 and entitled "Review of the Corporate Insolvency Law and Recommendation for the Amendment of Part V of the Companies Law" (the "April 12 Report"). A draft bill ("Draft Bill") was annexed to the report and the purpose of this Draft Bill was to repeal and replace the winding up provisions of the Companies Law (2004 Revision) (" the Law").

1.2 The April 12 Report included provisions removing, in the case of a compulsory winding up by the court, the jurisdiction of the Grand Court to appoint liquidators and to fix their remuneration. The Draft Bill gave creditors the right, in both a voluntary and compulsory winding up, to appoint liquidators and to determine the liquidators' fees.

1.3 The issue of liquidators' fees and expenses have, since the collapse of Sterling Bank & Trust Company Ltd. ("Interbank"), in 1974, been a matter of public interest in the Islands. In the Interbank liquidation, a local bank went into liquidation and there were many local depositors and creditors who were unable to recover any significant return. The expense of the liquidation, which had started as a voluntary winding up, was blamed for their misfortune.

1.4 The April 12 Report was completed without the benefit of comments from the judiciary. As the Privy Council noted in its June 6, 2006 decision in *The Attorney General of the Cayman Islands v Cleaver et al*., the judiciary had not thought it appropriate to discuss with the then constituted Law Reform Commission issues that were pending in the appeal. The Privy Council case concerned the Grand Court's jurisdiction under section 107(2) of the Companies Law, which provides-

> "There shall be paid to the official liquidator such salary or remuneration, by way of percentage or otherwise, as the Court may direct, and if more liquidators than one are appointed such remuneration shall be distributed amongst them in such proportions as the Court directs.".

1.5 On 18th October 2002, the Grand Court had sat unprecedentedly in a three-man constitution (Smellie CJ, Sanderson and Henderson JJ) and in its judgment set guidelines for fixing the rates of remuneration for official liquidators and gave further directions regarding the determination of the amounts to be properly paid in particular cases.

1.6 The Court of Appeal had allowed the liquidators' appeal against the Grand Court judgment and construed section 107 in a way which allowed the stakeholders to determine their liquidator's remuneration in the first instance and limited the role

of the Grand Court to act in an appellate capacity when liquidators complained that the amount allowed by the stakeholders was inadequate. The Attorney-General "as guardian of the public interest" appealed the Court of Appeal decision. The Privy Council agreed with the Attorney General and held that the Court of Appeal's decision was reached on the basis of a misreading of the statutory scheme and that the day-to-day experience of liquidation matters acquired by the Grand Court's judicial members at first instance made the Grand Court well-placed to identify problems that in a Cayman Islands context merited the Grand Court's attention.

1.7 The Privy Council found that the Grand Court had the jurisdiction to issue guidelines for fees, rates and to give directions regarding the fees, costs and time chargeable and the procedures to be followed in winding up and liquidation proceedings. Lord Mance delivering the judgment stated -

> "The Board has concluded that the Court of Appeal based its decision on an erroneous understanding of the role of the Grand Court. The correct view, now accepted even by the liquidator's counsel, is that the Grand Court had power to set guidelines and procedures for the fixing of liquidators' remuneration. The Grand Court correctly acknowledged that in doing this the court should place great weight on prior approval by the creditors committees' where they exist. It was however open to the Grand Court to order that, even after approval by creditors or a creditors' committee, the liquidators should submit the fees so approved to the court for its final decision.".

1.8 After the Privy Council upheld the Grand Court's ruling, the Attorney- General suggested that the Law Reform Commission give further consideration to the April 12 Report in light of the decision. The Commission then decided to confer with the judiciary to seek their comments on the April 12 Report. On 24th October 2006 the Commission met with the Chief Justice in a consultative session and by a memorandum dated 30th October 2006, a copy of which is attached as Appendix B, the Chief Justice formally presented the collective views of the judiciary.

1.9 At its meeting of 20th January 2007 the Commission, after considering the issues raised and the various recommendations made by the judiciary, decided to also consult with the Law Society and the Cayman Islands Society of Professional Accountants ("CISPA") on one of those issues, namely the insolvency test proposed by the Commission in the April 12 report. The Commission received responses on this issue from CISPA and the law firms of Ogier, CISPA, Maples and Calder, Appleby and Walkers. This supplemental report and the amended Bill set out in Appendix A have been prepared after considering the comments of the judiciary and the aforementioned law firms and CISPA.

## 2. EXECUTIVE SUMMARY

2.1 This supplemental report follows on the report and Draft Bill of the Law Reform Commission dated April 12, 2006. The Draft Bill has been amended to reflect the contents of this report.

2.2 It is recommended that the Draft Bill be amended to delete the provisions which seek to empower creditors and contributories to remove a liquidator following an initial appointment by the court, appointed on the nomination of the petitioner. Having regard to the concerns of both CISPA and the judiciary, the Commission concludes that the present arrangements should remain unchanged and that an official liquidator, once appointed, should only be removed from office by order of the court.

2.3 The remuneration of liquidators should continue to be approved by the court but the court should be guided in the assessment of fees by expert guidelines. Such guidelines could be prepared by the Insolvency Rules Committee after seeking advice from the industry and from the Cayman Islands Monetary Authority ("CIMA").

2.4 Section 94 of the Companies Law (2004 Revision) provides as follows-

> "94. A company may be wound up by the Court if-
>
> (a) the company has passed a special resolution requiring the company to be wound up by the Court;
> (b) the company does not commence its business within a year from its incorporation, or suspends its business for a whole year;
> (c) the company is unable to pay its debts; or
> (d) the Court is of opinion that it is just and equitable that the company should be wound up.".

In accordance with section 95 of the Law a company shall be deemed to be unable to pay its debts if-

> (a) a creditor by assignment or otherwise to whom the company is indebted at law or in equity in a sum exceeding one hundred dollars then due, has served on the company by leaving at its registered office a demand under his hand requiring the company to pay the sum so due, and the company has for the space of three weeks succeeding the service of such demand, neglected to pay such sum, or to secure or compound for the same to the satisfaction of the creditor;

(b) execution of other process issued on a judgement, decree or order obtained in the Court in favour of any creditor at law or in equity in any proceedings instituted by such creditor against the company, is returned unsatisfied in whole or in part; or
(c) it is proved to the satisfaction of the Court that the company is unable to pay its debts.

In the April 12, Report it was recommended that section 95 together with sections 34 (2) and 37 (6) be amended to provide for a balance sheet test of insolvency. The Commission now recommends that there should be no changes to sections 95, 34(2) and 37(6) of the Law. After wide consultation the Commission concluded that there is not enough support for the changes in as much as three major law firms were of the opinion that the proposed changes could be potentially damaging to the financial services industry. The Commission is of the opinion that the current legislation is sufficiently flexible as it stands to allow the courts in appropriate circumstances to take into account the balance sheet test.

2.5 Notwithstanding the Commission's opinion that the test for insolvency in the existing Companies Law should remain unchanged, the Commission is sensitive to concerns about the potential for "asset stripping" by the directors and officers of a company. As a consequence and in order to ensure certainty as to the liabilities of directors the Commission is of the opinion that it should in the future consider further revision of the Companies Law to set out more comprehensively in statutory form the duties of directors.

## 3. ISSUES RAISED BY THE JUDICIARY

3.1 In his letter of 30th October 2006 by way of introduction, the Chief Justice wrote-

> "First of all I wish to reiterate that we welcome this initiative to modernize the Law and Practice relating to this large and important area of corporate litigation. By and large, the proposals would, in our view, enhance the legislative framework towards that objective. There are however, important areas of concern.".

3.2 The provisions of the April 12 Report and the Draft Bill that particularly concerned the judiciary were:

(a) section 105(2) and 108- replacement of liquidator appointed by the Court.
(b) sections 106 and 110- selection of Liquidation Committee and remuneration of Liquidator
(c) section 156- the composition and role of the Rules Committee
(d) section 53 (2)- International Co-operation;
(e) section 93 - the test for insolvency; and

(f) duties of directors.

The issues related to international co-operation and the composition and role of the Rules Committee were minor ones and the Draft Bill has been amended to take into account the views of the judiciary.

4. **REMOVAL OF LIQUIDATORS**

4.1 Below is a table which sets out the provisions of the Companies Law (2004 Revision) which deal with the removal of liquidators and the provisions of the draft Bill which would amend those provisions-

| Companies Law (2004 Revision) | Draft Bill |
|---|---|
| 107. (1) Any official liquidator may resign or **be removed by the Court on due cause shown**; and any vacancy in the office of an official liquidator appointed by the Court shall be filled by the Court. | 105 (1) When making a winding up order the Court (a) shall appoint ....... as liquidator.<br><br>(2) The liquidator so appointed ........continues in office unless and until (a) another person becomes liquidator in his place pursuant to a resolution of creditors or contributories .......<br><br>108 (1) An official liquidator may be removed from office by a general meeting of the company's creditors, if it is insolvent, or of the company's contributories, if it is solvent, summoned specifically for the purpose in accordance with the rules. |

4.2 The judiciary expressed grave concern with a policy that would allow for the removal of court appointed liquidators by resolution of the creditors. As the Chief Justice pointed out:

> "It would be unusual that a liquidator who is appointed by a court could be removed simply by resolution of the creditors or contributories. The appointment in the first place would have been after full judicial consideration of a petition on notice to all concerned.".

4.3 The judiciary was of the view that the distinction in section 108 of the Bill between "insolvent" and "solvent" failed to take into account that, in practice, the issue of solvency is, in many cases, not apparent until well after the winding up has commenced and creditors claims have been finally determined. During that

period it will not be possible to determine whether creditors or shareholders have the right to vote to remove a liquidator. The uncertainty would be commercially unacceptable.

4.4 The judiciary also expressed concerns over the added cost to the liquidation where the creditors removed a liquidator who had been in office for some time without the benefit of judicial consideration of all the circumstances to determine the best interests of the company in liquidation and all its creditors (not just those who are in a majority as to the value of their claims). This is particularly so since section 108 does not provide for any time limits so that it is possible that a section 108 resolution could be passed many months, or even years, after the winding up has commenced.

4.5 The Chief Justice pointed out that the provision would leave liquidators uncertain as to their protection under the law. An interim liquidator who had been in place for a number of months and commenced work would have to apply to the court for his discharge.

4.6 The above issue was discussed by the Commission and it was agreed that the Chief Justice’s objections to sections 105 and 108 were valid and that there was merit in CISPA's objections to section 105. While it was argued that section 105 increases competitiveness and transparency, the majority of the Commissioners were of the opinion that section 105 would wrongfully empower a private body to overrule the decision of the Court. While the Commission did not doubt that the objects of section 105 were indeed legitimate it was agreed that the advantages of having such a selection of a liquidator as proposed by section 105 were outweighed by the disadvantages indicated by the judiciary and by CISPA.

## 5. REMUNERATION OF LIQUIDATORS

5.1 Below is a table which sets out the provisions of the Companies Law (2004 Revision) which deal with the remuneration of liquidators and the provisions of the Draft Bill which would amend those provisions-

| Companies Law (2004 Revision) | Draft Bill |
|---|---|
| 107 (2) There shall be paid to the official liquidator such salary or remuneration, by way of percentage or otherwise, as the Court may direct; and if more liquidators than one are appointed such remuneration shall be distributed amongst them in such proportions as the Court directs. | Section 110<br>(3) It shall be the responsibility of the liquidation committee to determine the basis upon which the liquidator is to be remunerated and to determine the amount of his remuneration. |

5.2 The Chief Justice pointed out that section 110 of the Bill was a departure from the current law and practice. Unlike the case in England where creditors are most likely resident and thus able attend a meeting at which a truly representative and democratically elected liquidation committee could be formed, the judiciary consider that the position in the Cayman Islands is quite different. In the Cayman Islands practically all of the compulsory liquidations involve companies that are foreign owned. The winding up of a Cayman company may be a consequence of a foreign liquidation of the parent or affiliate. In practice, the Cayman liquidator will be working in conjunction with foreign liquidator or trustee. The result is that liquidators in the Cayman Islands may not be in direct communication with the creditors of the company in winding up.

5.3 The Chief Justice further noted:

> "Putting aside for the moment the local Cayman liquidations; take for example, a typical offshore bank or mutual or hedge fund liquidation. In these cases our liquidators themselves seldom, if ever, have any direct access to or dealings with the underlying depositors or shareholders."

5.4 The Chief Justice said he believed that both a question of policy and public interest were involved in this issue. It follows that it should be regulated by the court as an impartial body. This, he said, minimizes the concerns of conflict of interest. He also indicated that he was not convinced that there was a need to depart from the existing practice where the court supervises these issues. The Chief Justice indicated that he was of the view that the current system works well. Recourse to the Courts has been the only means by which the liquidators can get conclusive approval of their fees and expenses such as to prevent questions being raised subsequently.

5.5 The Chief Justice referred to section 110(4) and (5) of the Bill and said that these subsections clearly recognize the reality of the situation in the Islands where it may be very difficult to appoint liquidation committees in the Islands. Section 110(4) of the Bill provides for that ad hoc position where, in the absence of a liquidation committee, creditors may fix the remuneration of liquidators. The Chief Justice also indicated that notwithstanding the Court of Appeal decision, liquidators continued to make applications to the court for approval of their remuneration.

5.6 The Chief Justice was of the opinion that since he had been on the bench, that is since. February 1993, the established practice in the jurisdiction is for the liquidators to apply to the court for the approval of their fees. The court does not need to set rates; it must however ensure that fees are reasonable.

5.7 The research of the Secretariat to the Law Reform Commission has compared legislation in Commonwealth countries, such as Canada, New Zealand and

Australia and the research shows the importance that each of those jurisdictions place on the court having the jurisdiction to fix the remuneration of the liquidators. An Australian publication written by Martin Hirst of Gadens Lawyers[1], entitled "Remuneration of Insolvency Practitioners" lists some of the common complaints advanced by creditors in Australia with respect to the remuneration of liquidators:

(a) the fees are out of proportion to the size of the administration (proportion of assets taken out of a pool as a priority as payment for a practitioner's remuneration and expenses in connection with the administration);
(b) the hours claimed appear excessive in relation to the period in which the work was done;
(c) charging for work that creditors consider unnecessary;
(d) spending time on speculative investigations and recovery possibilities which would not be contemplated if funds were more limited;
(e) charging fees without regard to the relative complexity/difficulty of a particular administration/liquidation;
(f) the remuneration sought is higher than the estimate or indicative figure provided at an earlier date;
(g) assigning either too many or too highly qualified staff to tasks;
(h) taking too long to perform tasks;
(i) doubling-up of work;
(j) work in anticipation of liquidation has been carried out during the voluntary administration period; and
(k) the practitioner has declined to have the remuneration reduced below the time cost amount.

In principle, whatever procedure is in place must enable the court to identify and deal with issues of this sort. The Commission has not conducted any review of court liquidation files in order to ascertain to what extent issues of this kind have in fact arisen in this jurisdiction and to analyse the effectiveness of the review and approval process. However, the Commission believes that the formulation of detailed procedures is best left to the Chief Justice and the Insolvency Rules Committee who will have power to make practice directions or rules in the light of their practical day to day experience of these matters.

5.8 There are two quite separate issues relating to liquidators' remuneration, namely the method by which rates of remuneration are fixed and the method by which the reasonableness of the work done and the amount payable for doing that work is determined. The main issue in the Islands is the absence of any guidelines for the use of the court in fixing fee rates which are normally expressed as hourly rates rather than a percentage of realisations or distributions. The Chief Justice advised that it was a matter of policy as to what mechanism was put in place for the fixing

[1] 15th February, 2006

of fee rates. He suggested the appointment of independent assessors by CIMA and relevant professional societies such as CISPA to carry out the exercise of surveying the market here to determine the scale of fees appropriate given the local circumstances. The assessors would have to pay close attention to the concerns of the local practitioners (liquidators) whilst striving to come up with a competitive rate. Their report should then be prepared with respect to liquidator's remuneration and to make recommendations as appropriate. Rates could then be fixed subject to periodic reviews, a situation which, in his view, would still allow the court to carry out its role.

5.9 Following the Privy Council decision a Practice Direction 2006 (Appendix C) has been issued by the Grand Court relating to liquidators' remuneration, which provides:

(a) Liquidators appointed by or who act under supervision of the Court are required to make applications to the Court for the setting and approval of their fees and expenses.

(b) Where there is available a body of creditors (in the case of insolvency or doubtful solvency) or contributories (in other cases), who may be convened to consider the appropriateness and reasonableness of an application and who, to the satisfaction of the Court, may be regarded as fairly representational of the interests of creditors or contributors as a whole; the application must first be presented to that body for their consideration and opinion. All relevant information to enable that process must be provided for their consideration.

(c) The application will then be presented to the Court, along with their opinion, for its decision.

(d) Where, for any reason explained to the satisfaction of the Court (such as in certain cases of provisional liquidation) there is not available such a body of creditors or contributories, the application will be served upon any person or persons who may be acceptable to the Court as fairly representing the respective interests of creditors or contributories, as the case may be.

(e) Similarly, all relevant information must be provided and the application will be returned with their opinion for the decision of the Court.

(f) The provision of relevant information to the creditors, contributories or representatives will be as the Court may direct in each case.

(g) In cases where a Fee Protocol is already in place or is proposed as between the liquidator here and his counterpart overseas, there may be continued compliance with or accession to such Protocol (as the case may be), unless

the Court otherwise orders. The Protocol must be brought to the attention of the Court as soon as practicable.

(h) In any other case – for instance, where the value of the estate would be disproportionate to the costs of getting the creditors' or contributories' opinions - the application must be presented to the Court for approval, and subject to such directions as the Court might give.

5.10. The Commission agrees that the court should be guided in the assessment of fees by expert guidelines. Such guidelines could be prepared by the Insolvency Rules Committee after seeking advice from the industry and from CIMA. In the April 12 Report the Commission had recommended the establishment of an Insolvency Rules Committee which would be charged with the responsibility of enacting insolvency rules for the needs of the Cayman Islands financial services industry. The Commission believes that such a body could effectively formulate guidelines relating to the rates of fees.

## 6. TEST FOR INSOLVENCY

6.1 The test for insolvency proposed in the April 12 Report has been the subject of further consideration. The Commission, recommended in paragraph 6.5 of the April 12 Report that a company should be treated as insolvent if it is unable to pay its debts, including prospective and future liabilities, as they fall due or if the amount of its liabilities exceeds the amount of its assets. The Commission stated in paragraph 6.3 that-

> "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. 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……. It is generally accepted that whatever insolvency test is adopted in the Companies Law, it must apply to all companies for all purposes. However, the Commission cannot 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.".

6.2 When the April 12 Report was submitted to the Attorney-General this was a matter which was still controversial. Walkers had raised objections to the

introduction or codification of such a balance sheet test[2] and in the cover letter of transmittal to the Attorney General from the Commission dated 26 April 2006 the then Chairman, Mr. Nigel Clifford Q.C noted-

> "There has been some controversy regarding the balance sheet test and the effect of its implementation on CDO[3] business. I refer you in this regard to section 6 of the Report. I understand that CIMA is of the view that benefit could be gained from further consultation on this matter. If the Authority wishes to discuss this with you, then it presumably it will do so.".

6.3 The table in this paragraph compares the provisions of the Law, the draft bill and the UK insolvency Act 1986 which relate to the test for insolvency.

| Companies Law (2004 Revision) | The Draft Bill | Insolvency Act 1986 |
|---|---|---|
| 95. (1) A company shall be deemed to be unable to pay its debts if - ......(c) it is proved to the satisfaction of the Court that the company is unable to pay its debts. | 93. (1) A company shall be deemed to be unable to pay its debts if - ......(c) it is proved to the satisfaction of the Court that the company is unable to pay its debts as *they fall due*.<br><br>(2) A company is also deemed to be unable to pay its debts if it is proved to the satisfaction of the Court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. | 93. (1) A company shall be deemed to be unable to pay its debts if - ......(c) it is proved to the satisfaction of the Court that the company is unable to pay its debts as *they fall due*.<br><br>(2) A company is also deemed to be unable to pay its debts if it is proved to the satisfaction of the Court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. |

6.4 The Commission further recommended that section 34(2) and section 37(6)(a) be amended to link the company's ability to pay debts to the "meaning of section 93.". By section 34(2) the share premium account may be applied by the company by paying distributions or dividends to members. No distribution or dividend may be paid to members out of the share premium account unless, immediately following the date on which the distribution or dividend is proposed to be paid, "the company shall be able to pay its debts as they fall due in the ordinary course

[2] See submission of 23rd November 2005 in Appendix C
[3] Collateralized Debt Obligations

of business." The Commission had recommended that those latter words be replaced with "the company is able to pay its debts within the meaning of section 93." However, the provisions of section 93 would not permit the directors to take into account the affairs and prospects of the company, to satisfy themselves that the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.

6.5 Section 37(6)(a) of the Companies Law provides that a payment out of capital by a company for the redemption or purchase of its own shares is not lawful unless immediately following the date on which the payment out of capital is proposed to be made "the company shall be able to pay its debts as they fall due in the ordinary course of business.". The Commission recommended that those words should be replaced with "the company is able to pay its debts within the meaning of section 93."

6.6 The Commission is now of the view that although the April 12 Report borrows from the provisions of section 93 of the English Insolvency Act, it does not appear to have taken into account how the English Companies Act deals with the issue of redemption of share out of capital. The English Companies Act 2006 does not link the payment of shares out of capital to the meaning of section 93. Instead directors are able to consider the affairs and prospects of the company. They must satisfy themselves that immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts, and as regards its prospects for the year immediately following that date, that having regard to-

(a) their intentions with respect to the management of the company's business during that year, and
(b) the amount and character of the financial resources that will in their view be available to the company during that year,

the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year. In forming their opinion for the purposes of subsection (3)(a), the directors must take into account all of the company's liabilities (including any contingent or prospective liabilities).

6.7 The Chief Justice stated that, in the main, the members of the judiciary had no difficulty with the double test proposed by section 93. The Chief Justice noted however-

> "Very valid concerns were raised at our meeting [the meeting of 24th October] in respect of the imposition of the balance sheet test; that is: whether the books show that the net assets of the company outweigh its net liabilities, taking into account all actual, contingent and prospective liabilities. Some of these concerns are

> as to whether directors of Cayman investment vehicles or insurance companies would be obliged to stop trading, the moment they became aware that the balance sheet test was not being met, for fear of their own contingent liabilities to creditors or to subsequent investors.".

6.8 The Chief Justice indicated that while most petitions before the courts based on grounds of insolvency rely upon a current debt which has not been paid, there could be petitions properly grounded on claims for prospective or contingent debts, where it can be shown that the company is insolvent if such liabilities are taken into account, and that such petitions should be admissible. The Chief Justice however noted that he was not aware of any case in which a petition was granted in respect of an entirely prospective or contingent claim. He felt that the test for insolvency and the statutory duties of directors and liquidators were competing matters of policy to be resolved as such. Thus the solution should not be the imposition of a balance sheet test but the express setting out of the duties and obligations of directors and liquidators. According to the Chief Justice this would serve as deterrent to conflicts of interests, insider dealing, fraudulent or unfair preferences and asset stripping.

6.9 The term "unable to pay its debts" provides for a cash flow test of insolvency. It means that the company is unable to meet current demands irrespective of whether the company has assets which, if realised, would discharge its liabilities in full. The term "Value of company's assets less than the amount of its liabilities" provides for a balance sheet test ("balance sheet test") of insolvency. In determining insolvency on this basis a court is able to take into account contingent and prospective liabilities.

6.10 The balance sheet test is unlikely to assist an "unpaid creditor from outside the company, who may have no realistic means of obtaining sufficient evidence about its financial status on a 'balance sheet' basis, where contingent and prospective liabilities have to be evaluated and brought into the calculation. Since the 'cash-flow' test is based upon the more readily verified proposition that a company is unable to pay its debts as they fall due, and unpaid creditor can use his own debt as a means of establishing that this test is satisfied.".[4]

6.11 The balance sheet test turns on value of the company's assets. The difficulty is that under section 93 of the Bill only "contingent and prospective liabilities" may be taken into account. Arguably it follows that the value cannot be based on the company as a going concern where prospective asset values can be taken into account.

6.12 In Germany for example, under the Insolvency Statute, which became effective January 1, 1999, a company must file for insolvency if it is either illiquid or over-indebted. "Illiquid" means that the company is no longer able to pay its debts as

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[4] *Insolvency in Private International Law Second Edition-* Ian F. Fletcher 2005 158 Para 3.30.

they become due (so the same as in Cayman). "Over-indebtedness" means that a company's liabilities exceed its assets for which a special balance sheet has to be prepared. Under German insolvency law, a German court can take into account facts leading to conclude a positive prognosis for the future business of the company. Where there is a positive prognosis the balance sheet will take into account "on going concern values" of the assets and not "liquidation values" which would could be significantly less.

6.13 The number of companies incorporated in the Cayman Islands that are owned by nationals and companies incorporated in other jurisdictions far exceed the number of companies owned by residents doing business in Cayman. Therefore when it comes to reform of the Law it is necessary, as CIMA recommended when the April 12 Report was considered by the Commission, to see the views of both local and international practitioners to ensure that any amendments of the Companies Law did not damage the financial industry.

6.14 The Commission therefore in January 2007 sought the further input of the Law Society and CISPA on section 93 and its implication for the financial industry. The Commission received detailed responses from CISPA, Maples and Calder, Ogier, Appleby and Walkers.

6.15 The divergence of views was quickly noted in the responses from Walkers and from Maples and Calder. Maples and Calder summarized its views in a letter of 15th February 2007[5]-

1. "The test set out in section 93(2) (i.e. the balance sheet "or assets/ liabilities test) is a part of the current Cayman Islands law and practice and is in the interests of creditor protection.

2. If the amount of a company's liabilities (including prospective and contingent liabilities) exceeds the value of its assets, it does not necessarily follow that the directors must cause the company to cease trading or to petition for its winding up. That is the position now and would be the position under the proposed section 93.

3. If the amount of a company's liabilities (including prospective and contingent liabilities) exceeds the value of its assets, the directors should not make redemption or dividend payments to shareholders. That is the position now and would be the position under the proposed section 93.

4. Enforceable provisions limiting the recourse of creditors allow Cayman Islands companies to remain solvent on a cash flow and balance sheet basis and make proper distributions to shareholders.

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[5] See Appendix D

The enforceability of the limited recourse provisions on any transaction is backed by opinions from lawyers in each relevant jurisdiction (including the Cayman Islands). That is the position now and would be the position under the proposed section 93.

5. Where the creditors of the Cayman Islands companies have full recourse, directors have to be mindful of the solvency of the company on a cash flow and balance sheet basis before approving distributions to share holders. If those tests are not passed, distributions should not be made. That is the position now and would be the position under the proposed section 93.

6. The existing recommendations of the Law Reform Commission in relation to the proposed sections 93, 34 and 37 would not alter the type of the transactions that are undertaken by this firm, or the advice we give in relation to such transactions.”.

6.16 Walkers reiterated its objections in two letters sent, one on 15th February 2007 and the other on 27th February 2007[6]. In its letter to the Commission of 15th February, 2007 Walkers stated that “the potential ramification of the introduction of a balance sheet test into a well established jurisdiction that has relied on a pure cash flow test would severely prejudice the financial services industry of the Cayman Islands.”. Walkers noted that in particular CDO transactions would be adversely affected. It stated further-

> “We note that even where Liability Extinguishment (as defined in the Initial Submission)[7] is provided for, the liabilities will generally only be extinguished when the collateral to which the liability is expressed to be limited is exhausted, which will not be until the end of the transaction resulting in the possibility of the vehicle being balance sheet insolvent throughout the entire life of the transaction. Where, therefore, the assets of a CDO vehicle are at any time less than its aggregate liabilities, the balance sheet test as presently proposed (if it does not properly recognise and account for the particular cashflows of CDO transactions and the various deferrals of and "caps" on liability described in the Initial Submission) would prevent payments out of share premium and capital. This would be so even though the transaction would likely have been structured specifically to allow payments to be made to preference shareholders on any payment date based on amounts received during the preceding interest or collection period (subject to any other relevant restrictions agreed as part of the commercial terms of the transaction). Introducing a balance sheet test would therefore be somewhat contrary to the "cashflow" basis on which these transactions typically operate and

[6] See Appendix E

[7] “after the assets of the Company have been fully realized and exhausted, all sums due but still unpaid in respect of the Issuer’s obligations hereunder shall be extinguished.”

would risk (i) frustrating the original intentions of the participants in current outstanding transactions, and/or (ii) impeding the structuring of future transactions in line with current commercial expectations and market customs.

The cash flow test is the only viable option for these transactions since including the balance sheet test may prevent the payment of dividends/redemption payments in relation to the preference shares. Even the possibility that non-payment as described above might occur in these transactions would, in our view, be sufficient to cause market participants to consider whether the Cayman Islands is an inappropriate jurisdiction for the domiciling of special purpose companies if there is any possibility of the CDO vehicle being regarded under the law as technically balance sheet insolvent.".

6.17 Walkers also disagreed with the contention by Maples that the balance sheet test already forms a part of the law and practice in the Islands and stated that the present state of the law is that the definition of "unable to pay its debts" pursuant to section 94 (c) of the Companies Law (2004 Revision) is a pure "cash flow" test although they acknowledged that a more limited form of balance sheet test does exist under the just and equitable jurisdiction of the court.

6.18 Ogier[8] expressed its concern about the divergence of views between the two largest Cayman law firms. The firm was of the opinion that there was no justification for the proposed section 93 as the current state of the law has worked well and a change could have adverse consequences to Cayman's place in the market. Ogier also noted the absence of a balance sheet test in Jersey, one of Cayman's biggest competitors. Ogier opined that-

"An over- zealous desire to emulate English law, for the sake of only conformity, with no perceivable practical benefit to Cayman , is… to be avoided.".

6.19 Appleby[9] too was of the opinion that a change to the insolvency test proposed in April 12 report and by Maples and Calder was not necessary for the following reasons-

" (a) Changes to the existing insolvency test are not necessary to achieve greater creditor protection. There is sufficient scope under the court's just and equitable jurisdiction to consider the state of a company's balance sheet in determining insolvency.

(b) A perceived move to stricter regulation without clear and unequivocal benefit or reason will send a negative message to the international

[8] See letter in Appendix F
[9] See letter in Appendix G

financial services industry that has supported the Cayman Islands in preference to other offshore jurisdictions with respect to structured finance transaction.".

6.20 Appleby agreed with Walkers that the Companies Law (2004 Revision) is based on the English Companies Act 1862 and that the wording of the existing cash flow test set out in section 94 (c) of the Law is taken directly from the 1862 Act. According to Appleby-

> "It is clear and unambiguous and there is no suggestion that the second balance sheet test is to be imputed into its application.".

6.21 CISPA[10] was of the view that there is a need to clarify the test in the Islands and that a balance sheet test needs to be inserted. The association was of the view that there already has been a balance sheet test incorporated into the practical analysis of situations brought before the courts, and gave the example of *National Warranty Insurance Risk Retention Group*[11]. CISPA felt that updating the Companies Law in the way proposed in the new section 93 merely confirms the current situation and will serve to clear up any ambiguity that may exist in this regard. CISPA also agreed with the amendment to sections 34 and 37 on the premise that section 93 should apply to all parts of the Companies Law.

6.22 After exhaustive discussion and analysis of the arguments put forward by CISPA, the above-mentioned law firms as well as by the judiciary the Commission has concluded that no changes to sections 94, 34(2) and 37(6) of the Law should be recommended. A majority of the Commission felt that there was not enough support for the changes in as much as three major law firms were of the opinion that the proposed changes could be potentially damaging to the financial services industry. The majority of the Commission is of the view that the arguments put forward by Ogier and Appleby were particularly compelling and it was agreed that the current legislation is sufficiently flexible as it stands to allow the courts in appropriate circumstances to take into account the balance sheet test.

## 7. LIABILITY OF OFFICERS AND DIRECTORS

7.1 Intertwined with the discussion relating to insolvency were the discussions dealing with the duties and obligations of directors. The Chief Justice, as noted previously felt that this was matter to be dealt with together with the test for insolvency. The Chief Justice also raised the issue of whether an amended Companies Law should codify the duties of directors and whether the duty should be owed directly to creditors in some circumstances. He brought to the attention of the Commission the recent Supreme Court of Canada's decision in *People's*

[10] See letter in Appendix H
[11] Cause no 372 of 2003

*Department Stores Inv. v. Wise*[12] where the court held that there is no fiduciary obligation to creditors at the point of insolvency or in the vicinity of insolvency. He expressed the view that the Commission should consider whether the Cayman statute should bring certainty to the issue of director's duties, which at present has to rely on Commonwealth case law.

7.2 The duties of directors fall under two heads: -

- fiduciary duties of loyalty and good faith, and
- duties of care and skill.

The distinction between fiduciary duties and duties of care is reflected in differences in the pleading requirements, burdens of proof and the calculation of damages. Fiduciary duties such as the obligation of loyalty are individual duties.

7.3 Directors and officers have a duty to the corporation to ensure the corporation carries out its legal obligations to regulators. Misrepresentations to regulators violate this duty as well as the corporation's legal obligations. They also have a duty to report the insolvency of the company to their co-directors, the shareholders and the proper legal authorities and to take proper legal steps to reorganize or wind up the corporation for the benefit of the corporation's creditors and shareholders. Concealment of insolvency constitutes a violation of the officer's duties.

7.4 The distinguishing obligation of a fiduciary is the obligation of loyalty. A company is entitled to the single-minded loyalty of its directors. This core obligation can perhaps be best explained by dealing with the fiduciary duties under categories notwithstanding that they will often overlap. A fiduciary must exercise his powers honestly and in good faith for a proper purpose in the best interests of the company as a whole; he must not be party to the misapplication of company resources; he must not be party to the misapplication of corporate opportunity and confidential information; he must not place himself in a position where his duty and his interest may conflict without the informed consent of his principal; he must not fetter his discretion; he must act in accordance with the company's constitution and he must deal fairly as between different classes of shareholders. It must be remembered however, as Laskin, J. said in *Aero Service Corporation v. O'Malley et al.* (1973) 40 D.L.R. (3d) 371 at page 392-

> "The general standards of loyalty, good faith and avoidance of a conflict of duty and self-interest to which the conduct of a director or senior officer must conform, must be tested in each case by many factors which it would be reckless to attempt to enumerate exhaustively."

7.5 The duty is owed by a director to the company and not absent, special circumstances, to individual shareholders or creditors. While the company is a

[12] 2004 SCC 68,

going concern the duty is owed to the company for the benefit of the shareholders as a whole, in the event the company is insolvent the duty is owed to the company for the benefit of shareholders and creditors. In *Lonrho Ltd. v. Shell Petroleum* [1980] 1 W.L.R. 627. H.L. Lord Diplock said at 634:

> "it is the duty of the board to consider . . . the best interests of the company. These are not exclusively those of the shareholders but may include those of creditors."

7.6 In *Winkworth v Edward Barron Development Co Ltd* [1987] 1 All ER 114 Lord Templeman said at page 118:

> "But a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for payment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of directors themselves to the prejudice of the creditors."

7.7 In *Kinsela v Russell Kinsela Pty Ltd* (in liq) (1986) 10 ACLR 395 Street CJ said at page 401:

> "In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when the question of duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation to displace the power of the shareholders and directors to deal with the company's assets that, through the medium of the company are under the management of the directors pending either liquidation, return to solvency or the imposition of some alternative administration.".

7.8 Directors are not directly liable as such to creditors of the company; the proper plaintiff would be the company itself. A director may by agreement or representation assume a special duty to a creditor of the company, which would render him liable in damages at the suit of the creditor.[13] Directors may, in addition to their duty to the

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[13] *Kuwait Bank v. National Nominees Ltd. (P.C.)* [1991] 1 A.C. 187.

company, in special circumstances have a fiduciary duty to individual shareholders.[14]

7.9 The new English Companies Act 2006 now has codified the duties of directors[15] and it is recommended that should the government seek to wholly revise the Companies Law in the future the duties of directors should be expressly provided for as recommended by the Chief Justice in order to ensure certainty with regard to the liabilities of directors, particularly in cases where the company may be doing business in foreign jurisdictions.

## 8 CONCLUSION

The Commission thanks the Attorney-General for the opportunity to revisit the issues highlighted in this report and are satisfied that all relevant stakeholders have now been granted a full opportunity to participate in the review of this most important matter. The attached Bill incorporates the recommended changes in this report and in that respect supersedes the recommendations in the April 12 Report in the areas addressed in this report. As indicated the Commission intends in the near future to address the issues of the statutory duties of directors as an important corollary to this report.

Chairman

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[14] *Briess v. Wooley* [1954] A.C. 333 H.L. *Coleman v. Myers* [1977] 2 N.Z.L.R. 225 (N.Z.C.A.)
[15] Sections 170 to 181