Can a Director of an Insolvent Company

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Can a Director of an Insolvent Company Present a Winding up Petition?

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In the Matter of China Shanshui Cement Group Limited:

Sections 94(1) and (2) of the Cayman Islands Companies Law (2013 Revision) (the 'Law')**[1]** contain an exhaustive list of people authorised to present a winding up petition to the Cayman Court. They are:

1. The company;**[2]**
2. Any creditor (including any contingent or prospective creditors);**[3]**
3. Any contributory;**[4]**
4. Cayman Islands Monetary Authority (pursuant to the Cayman Islands regulatory laws);**[5]** and
5. The directors of a company where expressly provided for in the articles of association (without the sanction of a resolution passed at a general meeting).**[6]**

These provisions were considered by Mr. Justice Jones QC in a judgment handed down in *In the Matter of China Milk Products Group Limited* on 22 July 2011.**[7]** In that case, Mr. Justice Jones QC held that the intention of the Cayman Islands legislature when enacting section 94 of the Companies (Amendment) Law 2007 was to allow the directors of a company to present a winding up petition even in circumstances where the articles of association contained no express provision to do so and there had been no sanction by the shareholders.

This decision went unchallenged until 25 November 2015 when Ms. Justice Mangatal handed down

judgment in *In the Matter of China Shanshui Cement Group Limited.***[8]** The case concerned a winding up petition purportedly presented by China Shanshui Cement Group Limited (the 'Company') on the authority of the directors.

The directors did not have an express power to present a winding up petition in the articles of association and did so contrary to the wishes of at least two of the largest minority shareholders, who cumulatively held a majority shareholding (the 'Majority Shareholders').

The directors of the Company unsurprisingly relied on the decision of the Cayman Islands Court in *China Milk*. However, the Majority Shareholders submitted that *China Milk* had been wrongly decided and that the Court should not follow that decision.

Ms. Justice Mangatal held that section 94 was clear and unambiguous and that Mr. Justice Jones QC was wrong to interpret section 94 as allowing the directors of a company to petition for its winding up without the sanction of a shareholders' resolution or an appropriate authority in the company's articles of association.

This article discusses the status of the Cayman Islands law in relation to section 94 of the Law, the decision in *China Shanshui* and its likely impact.

The decision *In Re Emmadart Ltd.*

In order to fully understand the issues raised by *China Milk* and *China Shanshui* it is necessary to look back to 5 December 1978 and the judgment of Brightman J. in the English authority *In Re Emmadart Ltd.***[9]**

The receiver of Emmadart Ltd., who had been appointed to realise the company's assets, presented a winding up petition on behalf of the company in order to obtain the benefit of a rate exemption by West Norfolk District Council which it would grant when a winding up order had been made against a company pursuant to local council regulations.

Despite the fact that the petition was unopposed, Mr. Justice Brightman raised the issue of whether the receiver had capacity to present the petition in the name of the company. He assumed, for the purposes of the argument before him, that a receiver would have the same powers as the directors of a company and so the main issue before him was distilled into a single question: do the directors of an insolvent company, absent a resolution by the shareholders or an express provision in the articles of association, have the power to present a winding up petition?

It is important to note that, at the time the petition was presented in *Emmadart*, a practice had already developed in England whereby a director of an insolvent company would petition the court pursuant to a directors' resolution and without reference to the shareholders.

Brightman J. reviewed a number of cases from England, Ireland and Australia, and adopted the reasoning that an article of association, which purported to give the directors all the powers of the

company, was confined to the management of the company as a going concern and not its cessation through liquidation.

Accordingly, absent ratification by the shareholders or an express provision in the articles of association, the board of directors of a company could not present a winding up petition in the name of that company regardless of the practice that had developed.

This remained good law in England until the position was reversed by the introduction of section 124 of the Insolvency Act 1986 which specifically empowered directors to petition for the winding up of a company (and oppose it) thereby removing the effect of *Emmadart*.

The impact of *Emmadart* in the Cayman Islands

The first fully reported decision to cite *Emmadart* in the Cayman Islands was the 1998 decision in *Banco Economico S.A. v Allied Leasing and Finance Corporation***[10]** of Mr. Justice Smellie (now Chief Justice of the Cayman Islands).**[11]**

The only known director of Allied Leasing applied to discharge an *ex parte* appointment of joint provisional liquidators; however, the petitioning bank sought to argue that the director had no *locus standi* to make any such application. The case turned on whether *Emmadart* applied in circumstances where, as distinct from the authority to present a winding up petition, the board had a residual authority to seek to remove joint provisional liquidators.

Mr. Justice Smellie acknowledged that *Emmadart* was reversed in England by the enactment of section 124 of the Insolvency Act 1986; however, he also acknowledged that no such legislative provision had been enacted in the Cayman Islands and so *Emmadart*, in the view of Mr. Justice Smellie, still represented the status of the law in relation to directors' powers to present a winding up petition.

Having concluded that *Emmadart* was still good law in the Cayman Islands he went on to find that, even if the receiver had the same powers as the board of directors, the board could only cause a petition to be presented under the articles if a resolution was passed in a general meeting.

***China Milk*: *Emmadart* and *Banco Economico* are reconsidered**

This issue did not trouble the Cayman Islands Court again until April 2011 when the directors of China Milk Products Group Limited petitioned to wind up the company on the grounds of insolvency with the intention of applying for the appointment of provisional liquidators who would, in turn, attempt to restructure the company's debt to allow it to continue as a going concern.

When the petition was heard, Mr. Justice Jones QC invited counsel for the company to consider their arguments in relation to the power of the directors to present the petition and whether the winding up of the company could be achieved by alternative means.

Mr. Justice Jones QC acknowledged that the position before 1 March 2009 (which was the date that the Companies (Amendment) Law 2007, the Companies Winding Up Rules and the Insolvency Practitioners' Regulations came into force in the Cayman Islands) was that *Emmadart* still represented good law. However, he stated that the statutory landscape of the insolvency legislative provisions in the Cayman Islands had changed considerably following the Law Reform Commission's report that had led to the enactment of the abovementioned law, rules and regulations on 1 March 2009.

Mr. Justice Jones QC stated that *Emmadart* was specifically considered by the Law Reform Commission and that it 'was generally agreed that, in principle, the directors of a solvent company should not have the power to present a winding up petition in the name of the company on the just and equitable ground…[however], it was generally accepted that different considerations come into play if a company is insolvent or of doubtful solvency.'

Mr. Justice Jones QC further stated that the Memorandum of Objects and Reasons contained in the Companies (Amendment) Bill suggested that the Cayman Islands Government accepted the proposal to authorise the directors of insolvent companies incorporated before 1 March 2009 to present a winding up petition and to allow the shareholders of companies incorporated after 1 March 2009 to present a winding up petition on the grounds of insolvency. This led him to review sections 91 to 95 and 104 of the Law in order to determine what the legislature had intended by enacting the Law in light of the Law Commission's proposals. In particular, he noted that:

1. The Court's jurisdiction to make a winding up order was enlarged by section 91(d) of the Law to include foreign companies;
2. Part V of the Law and the Companies Winding Up Rules applies to exempted limited partnerships;
3. Those empowered to present winding up petitions was extended to include contingent or prospective creditors and the Cayman Islands Monetary Authority;
4. The right of contributories to present a winding up petition is restricted by section 94(3) of the Law;
5. The remedies available to contributories as an alternative to winding up are extended by section 95(3) of the Law;
6. Section 104 of the Law sets out two different regimes for the appointment of provisional liquidators; and
7. Part V of the Law has been amended to make a clear distinction between solvent and insolvent liquidations.

The general thrust of Mr. Justice Jones QC's reasoning was that, having regard to the 'overall legislative objective', it was clear that the legislature had not differentiated between solvent and

insolvent companies in the Law and, therefore, it was clear that they intended to circumscribe the rule in *Emmadart*. Further, the legislature cannot have intended to inconvenience the ability of the directors of an insolvent company to seek the protection which flows from the presentation of a winding up petition given the above-mentioned reforms that were implemented.

Accordingly, Mr. Justice Jones QC ruled that the directors of *China Milk Products Group Limited* could petition to wind up the company on the ground of insolvency.

In the Matter of China Shanshui Cement Group Limited

It is in these circumstances that the same issue (that is, whether directors of a purportedly insolvent company have the ability to present a winding up petition) came before Ms. Justice Mangatal in November 2015 when she was asked by the Majority Shareholders (who opposed the winding up of the company and the appointment of joint provisional liquidators) to find that *China Milk* was wrongly decided.

Facts

The Company was (and remains) a holding company for an international group of companies whose operating subsidiaries are located in the Peoples Republic of China, where they are a leading producer of cement.

On 10 March 2015, the Company issued USD 500,000,000 Senior Notes which were due in 2020. The Notes were repayable in 2020 but bi-annual interest payments were due on 10 March and 10 September each year. The interest payments due on 10 September 2015 were made, however the directors of the Company presented a winding up petition on the basis that a debt arising under the 2020 Notes was imminent and/or immediately due and payable, and the Company was unable to pay it. It was also pleaded in the alternative that it was otherwise just and equitable for the Company to be wound up. The petition was presented by a unanimous resolution of the directors.

Despite these representations by the directors, the Majority Shareholders opposed the petition, not least because the company had a market capitalisation of over USD 2.7 billion and, while the Company was cash flow insolvent, it was considerably balance sheet solvent.**[12]**

The Majority Shareholders of the Company filed/supported a joint summons seeking to have the petition struck out as an abuse of process of the Court on the grounds that the directors:

1. had not obtained a resolution of the shareholders of the company resolving that the company present a winding up petition; and
2. did not have the benefit of an express provision in the articles of association authorising the directors to present a winding up petition on behalf of the company.

Issues

Ms. Justice Mangatal identified a number of issues in the case and, although the main focus of the argument was whether Mr Justice Jones QC wrongly decided *China Milk*, the petitioners also sought to argue that:

1. the Company's articles of association allowed a petition to be presented by the directors in any event;
2. as a matter of law, *Emmadart* should not be followed; and
3. the court should substitute a creditor in place of the directors (if one was capable of substitution).

Consideration of the decision in China Milk

It is unusual for a judge sitting in a court of co-ordinate jurisdiction (in this case the Financial Services Division of the Grand Court) to call into question a decision reached by another judge – especially when that decision has been thoroughly reasoned. However, if the second judge is convinced that the first judge was wrong, the second judge is not bound to follow the earlier decision.

When reviewing the decision in *China Milk*, Ms. Justice Mangatal immediately noted that there were no adverse parties in *China Milk* who argued that the directors did not have authority to petition the Court and, in those circumstances, the arguments of the petitioning directors in *China Milk* had not been tested.**[13]**

She further noted that article 162(1) of China Milk Products Group Limited's articles empowered the directors to bring a winding up petition in any event and so any decision regarding s.94 of the Law arguably did not form part of the ratio of the decision in *China Milk*.

Ms. Justice Mangatal also carried out a comprehensive review of section 94 of the Law in similar terms to the exercise carried out by Mr. Justice Jones QC in *China Milk*. On the basis of that review, she felt compelled to disagree with *China Milk* for the following reasons:-

1. section 94(1) of the Law had not materially varied since the decision of Mr. Justice Smellie in *Banco Economico* and it was therefore difficult to see why the common law position, as decided in *Banco Economico*, would not continue to apply; 1. section 94(1) of the Law had not materially varied since the decision of Mr. Justice Smellie in *Banco Economico* and it was therefore difficult to see why the common law position, as decided in *Banco Economico*, would not continue to apply;
2. the changes made to the Companies Law following the Law Commissions Review in 2007, in particular, the decision of the legislature not to draw a distinction between solvent and insolvent companies in Part V of the Law, did not make section 94(1) ambiguous or unworkable. Indeed, Ms. Justice Mangatal found that the review committee had the benefit

of knowing how legislators in England had eliminated the effect of *Emmadart* which would point to the conclusion that the legislature purposefully left out a provision to remove the effect of *Emmadart*;

3. section 94(2) of the Law, which authorises the directors of a company to petition to wind up a company when authorised by the articles of association, confirmed the position that was previously reached in *Emmadart* that, where the directors are so authorised, they do not need to obtain the sanction of a resolution in a general meeting; and
4. the wording of section 94(1) of the Law was, in any event, clear and unambiguous and nothing identified by Mr. Justice Jones QC in *China Milk* rendered her interpretation of section 94(1) unworkable or impracticable.

As Ms. Justice Mangatal noted in her judgment, Mr Justice Jones QC undoubtedly reached the correct commercial decision in *China Milk* by affording a company that was in serious financial trouble the protection of the appointment of joint provisional liquidators with the opportunity to restructure. However, she could not agree that section 94 could be interpreted to allow directors the authority to petition the court to wind up a company. It is perhaps of note that the directors' petition in *China Shanshui* was opposed by a majority of the shareholders and the Company was experiencing a short term cash flow difficultly as opposed to a more fundamental problem.

Alternative submission: powers under the Company's Articles of Association

The petitioners sought to argue that a specific article of the Company empowered the directors of the Company to present a winding up petition. The argument mirrored a similar argument that had been deployed and rejected in *Emmadart*. However, the petitioners sought to convince the Court that the wording in the Company's article was different to that in Emmadart Ltd's articles and therefore empowered the directors to present a petition.

Ms. Justice Mangatal reviewed the wording of the Company's article which provided, *inter alia*, that the 'management of the business of the Company shall be vested in the Board which … may exercise all such powers and do all such acts and things as may be exercised or done or approved by these [sic] Company and are not hereby or by the Law expressly directed or required to be exercised or done by the Company in general meeting …'

Despite the fact that the wording of the Company's article was different to the wording of Emmadart Ltd.'s article, Ms Justice Mangatal found that no significant distinction could be drawn between the articles because they were both concerned with the powers invested in a director to manage the company (as opposed to 'destroying' the company). Accordingly, this argument was rejected.

Alternative submission:* Emmadart *should not be followed in any event

In what was described as a 'sweeping submission', the directors sought to convince the Court that

Emmadart should not be followed in any event. Ms. Justice Mangatal acknowledged that *Emmadart* was an unpopular decision that had not been followed in a number of other Commonwealth jurisdictions, however, given that she had found that the law reforms that had taken place in 2007 left the common law position in relation to *Emmadart* intact, Ms. Justice Mangatal ruled that she should not take it upon herself to sweep all of the reforms away.

In particular, she acknowledged that: (i) the decision in *Banco Economico* had not been questioned as being correct; and, (ii) in *China Milk*, Mr. Justice Jones QC had acknowledged that companies doing business in the Cayman Islands had previously ordered their affairs on the basis that *Emmadart* was applied in the Cayman Islands.

Alternative submission: substitution of a creditor as petitioner

The final argument deployed by the directors was an attempt to convince Ms. Justice Mangatal that, if she was against them on all of the above arguments, she should substitute the directors as the petitioning party with a creditor.**[14]** Ms. Justice Mangatal did not have to grapple with the intricacies of this argument given that no creditor had come forward to confirm its intention to apply to be substituted for as a petitioner. However, there were two issues raised as a result of this argument:

1. whether the Companies Winding Up Rules allow for a creditor to be substituted in a petition presented by a company or contributory. The Court tentatively expressed the view that only a creditor could be substituted for another creditor**[15]** (as opposed to a creditor being substituted for a contributory or the company in a petition presented by a contributory or company **[16]**); and,
2. whether the Court has an inherent jurisdiction to substitute a creditor. The petitioners referred to the recent Cayman Islands Court of Appeal authority *In re Dyxnet Holdings Limited* **[17]** in which it was held that the court retained an inherent jurisdiction to make such an order where the Companies Winding Up Rules did not purport to govern the circumstances in which substitution could be made and where there are no provisions that were inconsistent with the power. As foreshadowed above, Ms. Justice Mangatal did not have to resolve this issue given the fact that no creditor had made any such application.**[18]**

Comment: *China Milk* vs. *China Shanshui*

The feature that runs through each of the cases (*Emmadart*, *Banco Economico*, *China Milk* and *China Shanshui*) is relatively simple: did the relevant legislation allow directors to petition to wind up a company?

In *Banco Economico* and *China Shanshui*, both judges carefully examined the Law and came to the conclusion that the wording of the statute was clear and that, if the legislature had intended to remove the effect of *Emmadart*, it would have done so in a way similar to section 124 of the

Insolvency Act in England.

In *China Milk*, the judge came to the opposite conclusion after reviewing a voluminous amount of material that was in circulation as part of the consultation process before the Companies Law (2007 Revision) was introduced on 1 March 2009. It was the underlying material that led him to the conclusion that the legislature must have intended to abolish the rule in *Emmadart*.

There is no doubt that section 94 of the Law is clearly drafted and unambiguous. The divergence of judicial opinion in the present case seems to have arisen because of the unpopularity of the decision in *Emmadart* coupled with the strong public policy reasons for allowing a director to petition when the Discussion *Emmadart* is widely acknowledged, at least in England and other Commonwealth jurisdictions, to have been an unpopular decision due to the fact that it curtailed the common practice in England and Wales of allowing directors to petition to wind up a company (in circumstances where the company was insolvent). Such was the negative impact of *Emmadart* that the common law position was completely reversed by English Parliament after judgement had been handed down.

However, there are competing considerations at play. On the one hand, directors are tasked with running the business of the company and the fiduciary duties that they owe are to a company's shareholders. This raises several questions:

1. why should a director petition to wind up a company if the majority of the shareholders want the company to continue to exist;
2. why should the company bear the cost of presenting a winding up petition in the absence of any creditor who is willing to do so; and
3. what if a director seeks to wind up a company when a creditor may have confidential commercial reasons, unknown to the director, for choosing not to do so?**[19]**

On the other hand, as Mr. Justice Jones QC highlighted in *China Milk*, when a company ceases to be a going concern and it is 'balance sheet' insolvent the shareholders cease to have any interest in the assets of the company because no distributions will be made to them – their interest expires as soon as the company becomes insolvent. In these circumstances it is arguable, as a matter of public policy, that directors should be able to ensure that the company's creditors are protected and that the company can be wound down in a timely and orderly fashion.

At the centre of these two divergent views is the board of directors. It is likely that the board of directors would only petition to wind up a company on the grounds that the company is unable to pay its debts (but may be capable of being restructured through a 'soft touch' provisional liquidation **[20]**) or that it was just and equitable to do so. In those circumstances the directors should always consider what liability they would be exposed to personally if they decided to petition to wind up the company.

If, for instance, a board of directors was empowered to present a winding up petition and they did so in the belief that the company was insolvent when it was not, it is easy to imagine the damage that would be caused by halting the company's business. Would it be unreasonable for the shareholders to then pursue the directors for damages in these circumstances?**[21]**

Whatever the arguments for and against directors having the authority to petition the court to wind up a company, one thing seems to have been decisively determined in the Cayman Islands:**[22]** directors do not have the authority to petition to wind up a company unless they are empowered to do so in the articles of association**[23]** or they have the sanction of the shareholders at a general meeting.

Notes

1 There have been a number of revisions to the Cayman Islands Companies Law during the course of the case law referred to in this article; however, there have been no material changes to provisions of what is now section 94 of the Law during the time period that this article refers to (i.e. since 1 December 1961, when the Law was originally enacted). The current revision of the Cayman Islands Companies Law is the 2013 Revision.

2 Section 94 (1) (a).

3 Section 94 (1) (b).

4 Section 94 (1) (c).

5 Section 94 (1) (d).

6 Section 94 (2).

7 2011 (2) CILR 61. The decision was concerned principally with section 94(1)(a) of the Companies Law (2009 Revision).

8 Unreported – Cause No: FSD 178 of 2015.

9 [1979] 1 Ch. 540.

10 1998 CILR 102.

1 1 *Emmadart* was cited in *Re Global Opportunity Fund [1997] CILR Note 7*, however, a full transcript of the judgment is not available.

12 For the purposes of Part V of the Law, the Cayman Islands applies a 'cash flow' insolvency test as opposed to a 'balance sheet' insolvency test

13 In *China Milk* all parties wanted joint provisional liquidators to be appointed in order that the company could be re-structured.

14 Two groups of Note holders supported the petition to wind up the company. One group of note holders also held just under 21% of the company's issued shares.

15 Companies Winding Up Rules 2008, Order 3, rule 10.

16 Mr. Justice Jones QC has previously substituted a creditor for a company in *In Re Xinhua Sports & Entertainment Ltd.* (unreported) FSD 48 of 2011 – AJJ.

17 (unreported) CICA 20 February 2015. See in particular paragraph 48.

18 It may have been the case that the creditors supporting the petition were contractually barred from presenting a winding up petition. This is specifically provided for in section 95(2) of the Law.

19 Section 95 of the Law gives the Court wide powers to make any alternative orders to winding up the company and even provides for the petition to be adjourned conditionally or unconditionally which arguably mitigate against the draconian effect of ordering a company be wound up.

20 See s.104(3) of the Law

21 Of course, in the Cayman Islands the articles of association regularly indemnify directors unless they have acted dishonestly or fraudulently or there has been willful neglect or default in fulfilling their duties.

22 Note: because *China Milk* and *China Shanshui* are both decisions of the Financial Services Division of the Grand Court, it is open to a petitioning director to argue that *China Milk* should be applied as opposed to *China Shanshui*. However, Ms. Justice Mangatal specifically considered *China Milk* and therefore it is likely that the Financial Services Division will be more inclined to follow *China Shanshui* until a similar case is appealed to the Cayman Islands Court of Appeal or the Law is changed.

23 For companies incorporated after 1 March 2009.

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