Cayman Islands Court of Appeal validates test under section 99 of the Companies Law

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The Cayman Islands Court of Appeal has provided much needed clarification of the test for validating certain transactions by companies that are subject to a winding up petition, pursuant to section 99 of the Companies Law (2020 Revision) (the "**Companies Law**").

The Legal Issue of Principle

Section 99 operates to bring down a curtain from the date of presentation of a winding up petition which operates as the "commencement of the winding up". All dispositions of property and alterations in the status of members are "void" for all purposes of the liquidation from that date (rather than the later date when a winding up order is actually made), unless a Court is prepared to make a "validation order". Since Section 99 only takes effect retrospectively, if and when a winding up order is made there is no certainty before the making of the order that transactions will, in fact, ever be avoided. Until the petition is heard the company and its counterparties are in a form of legally uncertain twilight zone which, in practice, means it may limit business. That prejudicial uncertainty, caused by the mere presentation of a winding up petition, may last for some considerable time, especially in the case of just and equitable petitions.

It is therefore important that during that period of uncertainty the Court is able to provide relief by validating transactions. The problem is that there has thus far been no attempt to identify a comprehensive statement of principle that can apply both to an insolvent winding up and a just and equitable petition. The textbooks and many of the cases deal with the Section 99 validation of dispositions only in the context of creditors' petitions and have often expressed the purpose of the Court's discretion to preserve the *pari passu* principle of distribution (see McPherson & Keay's Law of Company Distributions 4th ed 7-07). Thus, in the case of an insolvent winding up a Court would make an order when there was no risk to creditors, but that does not say anything about the winding up of solvent companies.

There is only very sparse English case law on the principles to be applied in just and equitable

petitions. In *Re Fortuna Development Corporation* [2004-05] CILR 533, *Re Cybervest Fund* [2006] CILR 80 and *Re Torchlight* [2018] (1) CILR 290, the Cayman Courts have considered making validation orders when transactions were in the ordinary course of business but have not previously given guidance on other types of transaction. McPherson suggests somewhat tentatively that ordinary business transactions will be validated in solvent liquidations (see op cit. 7-028), but goes on to say that the discretion is unfettered and concludes by saying "unfortunately, apart from these rudimentary principles, no general principle has emerged, each case being determined on the particular circumstances."

In its thoughtful analysis in *Re China Shanshui Cement Group Ltd* (unrep.d 18 February 2020, CICA Civ. 31 of 2019) the Cayman Islands Court of Appeal has provided a comprehensive statement of principle for Section 99 which should apply both in the case of insolvent as well as solvent liquidations. This is instructive not only for the Cayman Islands but for other common law jurisdictions, many of which have near identical provisions.

Background

China Shanshui Cement Group Limited ("**China Shanshui**") is listed on the Hong Kong Stock Exchange ("**HKSE**"). One of its substantial shareholders, Tianrui (International) Holding Company Limited ("**Tianrui**"), presented a just and equitable winding up petition in respect China Shanhshui alleging misconduct in the conduct of its affairs and oppression because the management, with the support of two rival shareholders, Asia Cement Company ("**ACC**") and China National Building Materials Ltd ("**CNBM**") had improperly issued a substantial number of shares to related parties to dilute Tianrui as part of a scheme to squeeze Tianrui out of China Shanshui. This was oppressive conduct which Tianrui could hope to remedy since the Court has broad powers on a winding up.

In March 2019, China Shanshui applied under section 99 of the Companies Law seeking to prospectively validate the transfer of a large number of China Shanshui's issued shares to HKSCC Nominees Limited ("**HKSCC**") so that they could be traded through the HKSE's central clearing and settlement system, known as "CCASS". The shares included a number of the very shares which Tianrui contended had been improperly issued. The transfer of shares to HKSCC entailed a change in the legal ownership of the shares. Hence, HKSCC was unwilling to accept the transfer without validation.

The evidence was that under Hong Kong law once the transfer to HKSCC took place, the local Securities and Futures Ordinance made it difficult, if not impossible, for anybody to enforce rights to recover the shares. Tianrui argued that, because share transactions in CCASS are difficult to unwind, validating the transfer would undermine the very purpose of its winding-up petition by limiting the Court's ability to give relief that would reverse the oppressive conduct.

At first instance, Mangatal J dismissed this argument and made an order prospectively validating the transfer of the shares to HKSCC which would then permit those shares to be traded on CCASS. She held that the real purpose of section 99 was to prevent partly-paid up shareholders from evading

liability by transferring their shares to a straw man after a winding up had commenced, and as the shares sought to be transferred were all fully paid, the true objective of the section would not be frustrated by validation.

Mangatal J then applied the well-known test for validation set out in *Burton v Deakin Ltd.* [1977] 1 WLR 309, namely whether the reasons for the proposed transaction were those which “an intelligent and honest director” could reasonably hold in good faith. Once the director had given some reason, the burden, the judge held, shifted to a party opposing validation to present "compelling evidence" to prove that the transaction was not one which an intelligent or reasonable director would conclude.

Court of Appeal's Findings

In overturning this decision, the Court of Appeal accepted Tianrui's contention that the judge had misunderstood the purpose of Section 99 and had taken the wrong approach to validation under section 99. The rationale for Section 99 accepted by the judge was too restrictive. It clearly applied to all transfers of shares whether partly paid or not. Moses JA, delivering a unanimous decision, held that the fundamental purpose of section 99 is to maintain the status quo pending resolution of the winding up petition. For a solvent company *"preserving the status quo”* means *“permitting a company to conduct its business in a manner which enables it to survive notwithstanding the depressing effects which flow from the presentation of a petition. It enables the company to keep “ticking over”* (see paragraph 19 of the judgment). Any application for validation must be considered in light of this purpose, and the relief granted should not *"impede, undermine or preclude fulfilment of that purpose"*.

The Court of Appeal also adopted Tianrui's submission that in a just and equitable petition the status quo was not maintained if a validation order undermined the objective of stopping or reversing oppressive conduct. Having identified the fundamental purpose of section 99 and that Mangatal J had been in error, the Court of Appeal went on to conclude that the proposed transfer of shares into CCASS would have the effect of making it more difficult to unwind the transactions, thus interfering with the status quo.

The Court of Appeal also made a number of useful observations about the evidence to be provided by a company in support of such validation applications, and the "careful scrutiny" suggested by Burton v Deakin that should be applied by the Court. In particular, the Court of Appeal agreed that the test for challenging a validation order used in Burton v Deakin reflected the fact that the only basis on which the directors exercise of powers could be challenged was that the directors had not acted bona fide in the best interests of the Company. It was no accident that the judge in Burton paraphrased the test in Re Charterbridge. It is perfectly true that if that is the only basis on which directors are challenged the test is a fairly high one. However, as the Court of Appeal pointed out, if the challenge is on different grounds, the Court must carefully examine the evidence and not apply some form of presumption. The relevant transactions were being challenged by Tianrui on the basis that they were the result of an improper exercise of power. Re-examining the evidence, the Court of Appeal concluded that no real justification had been advanced for validation.

Relevance of Decision

The Court of Appeal's decision is one of few appellate decisions on this topic. Section 99 operates to help maintain the status quo of the Company at the date of the winding up petition so that a winding up petition can continue to achieve its purposes. In a creditor's petition that means that the discretion is exercised with one eye on the *pari passu* principle. In a just and equitable winding up, nobody should want to destroy the company and it is obvious that a Company should continue to trade when continuous trading represents the status quo. Individual transactions can obviously be challenged even if they are in the "ordinary course of business" but generally that requires a shareholder to show that the transaction was not bona fide. When a transaction does fall outside the ordinary course of business or otherwise undermines one of the purpose of the winding up then the Court should scrutinise the basis for validation with particular care.

Ogier represented the Petitioner in its successful application to the Cayman Islands Court of Appeal.

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