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Recent Judgment of the Cayman Islands Court of Appeal Concerning Validation Orders

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In the recent decision of *Aurora Funds Management Limited et al -v- Torchlight GP Limited*[1] the Cayman Islands Court of Appeal dismissed an appeal brought in respect of an order made by McMillan J in the Grand Court validating certain payments made by Torchlight GP Limited (the "General Partner") in accordance with Section 99 of the *Companies Law*.

Background

The validation order which was the subject of the appeal was made during the course of proceedings involving a just and equitable winding up petition (Cause No. FSD 103 of 2015) (the "Petition"), which was presented on 18 June 2015 against Torchlight Fund LP (the "Partnership"), a solvent, closed ended fund which specialises in investment in distressed assets. The Petition was brought by various limited partners of the Partnership (the "Appellants"): (i) Accident Compensation Corporation of New Zealand ("ACC"), (ii) Crown Asset Management Limited ("CAML") and (iii) Aurora Funds Management Ltd ("Aurora"). The General Partner, which has defended the Petition proceedings on behalf of the Partnership, was the respondent to the appeal (the "Respondent").

Grand Court Decision

On 22 January 2016, Clifford J granted an injunction against the General Partner which prevented it from making any disposition of the assets of the Partnership to related parties without the consent of the Appellants or an order of the Court (the "Related Party Injunction"). The terms of the Related Party Injunction anticipated that an application to the Court could be made to validate payments which, if granted, would therefore not be prohibited by the Related Party Injunction.

Section 99 of the *Companies Law* provides that, upon the making of a winding up order:

> *"[A]ny disposition of the company's property and any transfer of shares or alteration in the status of the company's members made after the commencement of the winding up is, unless the Court otherwise orders, void."*

Validation orders made pursuant to Section 99 are commonly sought by entities which are the subject of insolvency proceedings, as they prevent any dispositions made by the relevant entity, subsequent to the presentation of a winding up petition being rendered automatically void in the event that a winding up order is ultimately made.

The General Partner issued a summons on 8 September 2016 seeking an order from the Court, pending the determination of the winding up proceedings, sanctioning various dispositions (several of which would otherwise have been caught by the

[1] (Unreported, 27 April 2018) (CICA 1 of 2017)

Related Party Injunction) such as *inter alia*: (i) payments due under a loan to a third party; (ii) payments to other entities in the Torchlight Group; (iii) payments to legal advisors; and (iv) payments to various service providers.

The parties had essentially agreed for the purposes of the hearing before the Grand Court that the correct principles to be applied by the Judge when considering making a validation order were established by Henderson J in *In the Matter of Fortuna Development Corporation*[2] and supplemented by Smellie CJ in his subsequent Judgment in *In the matter of the Cybervest Fund*[3]. In *Fortuna* Henderson J indicated that in the case of a solvent company, the following four elements had to be established before an applicant would be entitled to a validation order:

1. The proposed disposition must appear to be within the powers of the directors.
2. The evidence must show that the directors believe the disposition is necessary or expedient in the interests of the company.
3. It must appear that in reaching the decision to make the disposition the directors have acted in good faith (the burden of establishing bad faith being on the party opposing the application).
4. The reasons for the disposition must be shown to be ones which an intelligent and honest director could reasonably hold.

Here, after considering the test in *Fortuna*, McMillan J noted the following:

> *"It is important to note that the test is not a high one. Although much time and indeed energy have been expended upon this issue, the Court reminds itself both that these are interlocutory proceedings only, where no final determinations of facts have yet been made, and moreover that it is not the function of the Court to place itself in the role of directors or of a General Partner or directly assume their business responsibilities."*

Turning then to Cybervest, after mentioning Smellie CJ's cautionary note relating to cases in which '*irregularities in the conduct of the company can be shown*', McMillan J observed that, '*at this stage of proceedings the alleged circumstances of the instant case cannot be said to be comparable in scope or severity with those alleged in [Cybervest], taking the matter broadly as it stands as a whole.*'

Ultimately, McMillan J decided that the relevant legal criteria was satisfied on the basis of the evidence before him, and subsequently made an order on 6 December 2016 (the "Validation Order"), which granted the validation application and, after a further hearing on 19 January 2017, made further detailed orders to give effect to the Validation Order.

Court of Appeal Decision

Whilst it was not in dispute that McMillan J had applied the correct legal test, the Appellants' principal complaint was that McMillan J had failed to give adequate reasons for his decision to make the Validation Order. The Appellants also complained that there was '*a demonstrable failure*' by McMillan J to consider the relevant evidence, and that McMillan J's decision to make the Validation Order '*cannot be reasonably explained or justified and the decisions he made were decisions that no reasonable judge could have reached.*'

The Appellants based their contentions on various authorities such as:

- *English -v- Emery Reimbold & Strick Ltd*[4] *(this indicated that a judge is required to provide adequate reasons in order to enable a losing litigant to understand why they lost);*
- *Tommy Crinion et al -v- IG Markets Ltd*[5] *(this indicated that a judge who simply wholesale adopts the submissions put forward by one party will not discharge his duty as a judge); and*
- *Henderson -v- Foxworth Investments Ltd*[6]*.*

[2] [2004-05] CILR 533
[3] [2006] CILR 80
[4] [2002] 1WLR 2409
[5] [2013] EWCA Civ 587
[6] [2014] UKSC 41

In response, leading counsel for the General Partner[7] submitted that McMillan J had correctly adopted the *Fortuna* test, addressed all of the Appellants' objections, considered all of the evidence, applied the appropriate principles and arrived at a rational decision. He noted that in considering the evidence, McMillan J had particularly relied on: (i) a letter from the Partnership's administrator, which confirmed that the calculation of the fees paid to the General Partner were indeed correct; and (ii) the consistent unqualified audited accounts prepared by the Partnership's auditors.

Further, in response to the Appellants' contention that McMillan J had given insufficient reasons for his decision, the Court of Appeal was taken to the House of Lords decision in *South Bucks District Council and another -v- Porter (No 2)*[8], which indicated that although reasons for a decision should be intelligible and adequate to enable the reader to ascertain what was decided, they could, depending on the nature of the issues in dispute, be briefly stated.

In its Judgment, the Court of Appeal noted that there was very little in dispute between the parties as to the relevant principles which should apply when the Court is considering making a validation order, nor was it said that McMillan J had incorrectly applied them, and that to the extent to which there were any differences in the parties' suggested approach, it was primarily a matter of emphasis regarding certain passages of *Re Burton & Deakin Ltd, Fortuna* or *Cybervest* respectively. Ultimately, the only question that the Court of Appeal was asked to consider was whether McMillan J exercised his discretion under Section 99 in a demonstrably rational manner when he applied the relevant principles to the facts.

After a review of the relevant authorities, the Court of Appeal acknowledged that whilst those authorities indicated that there were strong reasons why as a general proposition Judges are required to give reasons for their decision, nonetheless they indicated that a departure from such a rule at first instance should not mean that as a general rule an appeal against such a decision must automatically be granted. Rather, the appellate court should very closely analyse the evidence and submissions made at first instance to determine whether justice had been done. In the words of Lord Brown in *South Bucks District Council and another -v- Porter (No 2)*, the appealing party must prove to the satisfaction of the Court:

> *"[T]hat he has genuinely been substantially prejudiced by the failure to provide an adequately reasoned decision…"*

The Court of Appeal concluded that McMillan J had applied the correct test. It indicated that in order for McMillan J's decision to be successfully challenged on appeal, it was necessary for the Appellants to demonstrate that McMillan J had proceeded on some wrong principle, or otherwise misunderstood the law which he was required to apply, or the evidence which the parties provided for his consideration. The Court of Appeal was not satisfied that the Appellants had demonstrated that and therefore found no reason to interfere with McMillan J's decision.

In terms of the costs of the Appeal proceedings, the Court of Appeal made the exceptional order that the General Partner's costs be paid immediately, on the basis that the Appeal had been finally disposed of, rather than the usual order for costs following the final determination of the substantive Petition proceedings.

**Torchlight GP Limited and Torchlight Fund LP have been represented by Conyers Dill & Pearman during the course of the Petition proceedings and the related appeals. Oral closings in the petition proceedings were heard in late 2017, as at the date of writing this client alert, the Judgment has not yet been handed down.*

[7] John Wardell, QC
[8] [2004] UKHL 33; [2004] 1WLR 1953

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