Article

Cayman Court of Appeal Clarifies the Purpose of Section 99 of the Companies Law

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In an important decision in *Tiranrui (International) Holding Company Limited ("Tiranrui") v. China Shanshui Cement Group Limited ("the Company")*, the Court of Appeal of the Cayman Islands clarified the purpose of s.99 of the Companies Law (as revised) – the equivalent of s.127 of the English Insolvency Act 1986 – and the test and scrutiny to be applied in hearings of an application for a Validation Order.

Introduction

Tiranrui successfully appealed a Validation Order made by Mangatal J which pursuant to s.99 of the Companies Law validated a proposed transfer of shares in the Company held by 18 of the Company's shareholders on the register (representing 43.96% of the Company's issued share capital) to the Hong Kong Securities Clearing Company Nominees Limited (HKSCC) to allow the beneficial interests in the shares to be traded on the HKSE.

The effect of a s.99 Validation Order is that any disposition of a company's property between when a winding up petition is presented and when the petition is determined by the Court shall not be void (which they otherwise would be) if the company is wound up; those transactions cannot usually be unwound by the liquidator. Section 99 of the Companies Law provides that:

"When a winding up order has been made, any disposition of the company's property and any transfer of shares or alternation in the status of the company's members made after the commencement of the winding up is, unless the Court otherwise orders, void."

Background

The Company is a Cayman Islands holding company whose wholly owned subsidiary, is one of the largest cement producers in the People's Republic of China (PRC).

In November 2014, the PRC prohibited any expansion of capacity or development of new projects in the cement industry. That meant that cement producers could only expand by way of acquiring/merging with existing producers.

As a result, the following cement producers sought to expand their holding in the Company and engaged in a bitter battle for control: (i) Tiranrui, (ii) Asia Cement Corporation (ACC), and (iii) China National Building Materials Co Ltd (CNBM).

A just and equitable winding up petition was presented by Tiranrui on 4 September 2018 complaining of oppressive conduct and attempts to squeeze them out of the Company on the part of both CNBM and ACC by, amongst other things, issuing loan notes to associated parties which were convertible to shares in order to dilute Tiranrui's shareholding.

The Company sought to strike out the petition. The CICA judgment of 5 April 2019 overturning Mangatal J's strike out of the petition contains a comprehensive overview of that application.

Tiranrui's basis for the petition was much the same as for the appeal here, namely that the proposed transfer of shares formed part of a conspiracy aimed to dilute its shareholdings in the Company and as such, should not receive validation, as the purpose of the transfer fell outside of the purposes for which s.99 exists.

First instance findings

At first instance, Mangatal J accepted the Company's position that the transfer was aimed at reducing the purported illiquidity of its shares. In light of this, she concluded that in accordance with the test in *Burton v. Deakin Ltd* [1977] 1 WLR 390, the reasons for the transfer were those which an intelligent and honest director could reasonably hold in good faith and had a clear commercial basis.

Mangatal J also adopted the Company's submission that the scope of s.99 was limited to preventing shareholders from evading liability for partly paid up shares by effecting a transfer after a winding up had commenced. The shares in question were fully paid-up. It was for these reasons that Mangatal J determined that the purpose of s.99 would not be contravened if the transfer was to be sanctioned.

The Appeal

The fundamental questions for the Court of Appeal were 1) whether Mangatal J misunderstood the purpose for which s.99 exists, and 2) what principles ought to apply so as not to frustrate the correct purpose of s.99?

Principles and facts to be considered

The Court of Appeal found that Mangatal J had erred by adopting the narrow interpretation of s.99 advanced by the Company. Whilst historically partly paid shares might have been an issue for the Courts to guard against, it was no longer an issue of any significance in modern times.

The Court of Appeal reiterated two fundamental features of s.99, namely:

i. the purpose of validation itself is to preserve the status quo between presentation and determination of a winding up petition, so as to render effective s.99's retrospective avoidance function and

ii. s.99 applies equally, irrespective of whether a company is solvent or insolvent, trading or whether winding up is sought on the grounds of insolvency or on a just and equitable basis.

Taking guidance from *Burton v. Deakin, Re Fortuna Development Corporation* [2004-5 CILR 533], *Re Cybervest Fund* [2006] CILR 80, *Re a Company (No. 007130 of 1998),* and *In the Matter of Torchlight Fund LP* [2018] (1) CILR 290, the Court of Appeal confirmed that the court must satisfy itself that any application for a validation order does not undermine or frustrate the maintenance of the status quo pending resolution of the petition. The application of this principle will however vary from case to case.

The Court of Appeal cautioned against taking a light touch approach to validation applications merely because a company is solvent or because a transaction is in the ordinary course of business.

In a similar vein, the Court of Appeal doubted the rule established by *Burton* and *Fortuna* that the burden of proof should be on the party seeking to dispute the proposed validation as the Court should satisfy itself in each situation that the validation will not undermine s.99's avoidance function.

In the circumstances, the Court of Appeal found that a Validation Order approving the transfer of the shares to the HKSCC would not maintain the status quo since it would undermine the objective of reversing oppressive conduct in a just and equitable winding up (in the same manner as a validation order in a creditors' winding up which prevented *pari passu* distribution).

There was no evidence put forth as to why a holding company would seek to reduce the illiquidity of its shares in the ordinary course of its business, especially given that its business is in holding interests in subsidiaries and not the trading of its own shares.

The Court of Appeal was also of the view that a failure to take full consideration of contributory's arguments against validation could also prove to be a dangerous approach to hearing applications dealing with s.99.

For these reasons, the Court of Appeal overturned the decision of Mangatal J and refused to make the Validation Order.

Conclusion

The Court of Appeal decision is a welcome clarification of the law on validation. The Court of Appeal decision reconfirms the legislative purpose of s.99 of the Companies Law: that is, to maintain the status quo until the resolution of the winding up proceedings. The decision also confirms that the court should adopt a more cautious and critical view of the proposed dispositions sought to be sanctioned under the s.99 regime.

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