Alert   May 2020 | Cayman Islands

Pandemics and Pursuing Principled Practice: Avoiding the Pitfalls in Troubled Times

Authors: Margot MacInnis, Managing Director | **Prudence Pryce,** Manager | **Ben Hobden,** Partner | **Róisín Liddy-Murphy,** Attorney

As governments and economies respond to the macroeconomic impact of the latest global pandemic COVID-19, so too companies and individuals must respond to the microeconomic impact, making decisions that will affect both decision-makers and stakeholders alike.

During times of uncertainty, anxiety and financial pressures officers of a company making financial and operating decisions may enter into transactions that could ultimately become subject to claw-back claims in an insolvency situation or could find themselves digging into their own pockets to make contributions to the company's assets for its creditors.

The challenges facing directors who might be making choices about which creditors/suppliers to pay and decisions relating to production and ongoing operations is that they could later find those being viewed through a lens of insolvent trading.

So too, stakeholders (including creditors) ought to be alert to sins that could be committed by the minds behind the companies in which they have an economic interest, as there are certain remedies available to stakeholders through the appointment of an official liquidator.

Thou shalt not make payments that prefer certain creditors over others: a cause for voidable preference claims [The Companies Law (2020 Revision) (the "Law"), sec.145]

At a time when a company is unable to pay its debts within the meaning of section 93 of the Law, every conveyance or transfer of property, or charge thereon, and every payment obligation and judicial proceeding, made, incurred, taken or suffered by that company in favour of any creditor with a view to giving such creditor a preference over other creditors will be invalid if made, incurred, taken or suffered within six months immediately preceding the commencement of its liquidation.

In such circumstances, a liquidator may be able to claw-back transfers made during those six months prior to commencement of the liquidation by way of a voidable preference claim enforced through the Cayman Grand Court for the benefit of aggrieved stakeholders.

Preference in this context also captures related parties. In that, any payment made to a related party of that company will be deemed to have been made with a view to giving such creditor a preference. For the purposes of section 145 a creditor is treated as a "related party" if it has the ability to control the company or exercise significant influence over the company in making financial and operating decisions.

The decision of the Privy Council in *Skandinaviska Enskilda Banken AB (Publ) (Appellant) v Conway and another (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Ltd (Respondents) (Cayman Islands)*[1] strengthened the position of liquidators considering pursuing voidable preference claims and reiterates the underlying policy of a *pari passu* distribution amongst creditors in an insolvent company.

Here the liquidators succeeded with a voidable preference claim against a redeemed investor. The liquidators successfully contended that the payment to the redeemed investor ahead of other shareholders entitled to receive redemption monies amounted to an unlawful preference and was set aside under section 145 (1) of the Law. The Privy Council agreed with the assertion of the liquidators that the company was insolvent when the redemption payments were made and that the transactions constituted preferential payments and

[1] [2019] UKPC 26

distorted the *pari passu* principle of equal distribution between creditors. [2] As a result there is no reason why a liquidator should not be able to pursue common law remedies in the event that a transaction is rendered voidable by the operation of section 145.

Thou shalt not short sell thy creditors' interests: a cause for avoidance of dispositions made at an undervalue claims [Law sec.146]

Section 146 deals with transfers made at undervalue. Every disposition of property made at an undervalue by or on behalf of a company with intent to defraud its creditors will be voidable at the instance of its official liquidator.

Unlike the six-month look-back period that applies to voidable preference claims, any action or proceedings commenced by an official liquidator under this section has a six-year look-back period after the date of the relevant disposition.

For the purposes of this section, the burden of establishing an intent to defraud rests with the official liquidator. Practically speaking, this requires a review of the company's affairs, including examination of its books and records as well as its officers, as the case may be. This means that stakeholders will require the services of an official liquidator to pursue this type of claim for their benefit. Claims of this nature, whilst uncommon, are not impossible to pursue successfully.

The defence afforded a transferee under this section is where such transferee or any predecessor transferee has not acted in bad faith with respect to the undervalued property. In the event such disposition is set aside, the Court will grant certain considerations to the transferee or predecessor transferee in the defence of the action or proceedings.

Thou shalt not defraud thy creditors: a cause for fraudulent trading claims [Law sec.147]

If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, section 147 allows the liquidator to apply to the Court for a declaration under this section such that the Court may declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid mentioned are liable to make such contributions, if any, to the company's assets as the Court thinks proper. Such persons include the directors and officers of the company. As with section 146, the burden of establishing an intent to defraud rests with the official liquidator. This is a high burden to satisfy and can often prove to be challenging.[3]

Notwithstanding that fraudulent trading claims can be difficult to pursue, with the assistance of the right professionals, it is possible to succeed.

In the recent English decision of *Re Pantiles Investments Ltd (in liquidation); Pantiles Investments Ltd (in liquidation) and another v Winckler* [2019] EWHC 1298 (Ch), the liquidator brought an application against Ms. Winkcler, the former sole director and shareholder of Pantiles, for fraudulent trading under section 213 of the 1986 Insolvency Act[4] to recover from her a contribution to the assets of Pantiles in a sum equal to the deficiency to its creditors

The High Court referred to the test for knowledge for the purpose of fraudulent trading as set out in *Morris v Bank of India*[5]. It requires that:

- The defendant actually realised from their own observations or what they were told that the purpose of the transaction was to defraud creditors- but the defendant does not know every detail of the fraud;
- The knowledge has to be contemporaneous with the transaction – hindsight is not enough;
- Knowledge can include "blind eye" *knowledge i.e. "shutting one's eyes to the obvious*".

In Pantiles the Court found that Ms. Winckler's explanation regarding the structure of the transactions was improbable. The Court found that Ms. Winckler was a knowing party to an attempt to conceal the property and the proceeds of its sale from the creditors. The Court was satisfied that section 213 was engaged.[6]

It is rare for fraudulent trading claims to be brought by office holders, but this case is a valid reminder that in the right circumstances they can succeed.

[2] These principles were applied by Smellie CJ in *RMF Market Neutral Strategies (Master) Limited v DD Growh Premium 2X Fund* (unreported, 17.xi.2014)
[3] *ICP Strategic Credit Income Master Fund Ltd. Et al v. DLA Piper L.L.P. (US),* Case No. 13-12116 (REG), Adversary Proceedings No., 14-01835 Reg.
[4] Section 213 of the English Insolvency Act 1986 is identical to section 147 of the Law.
[5] [2004] BCC 404

How should stakeholders respond?

In a time of uncertainty and anxiety, stakeholders should be mindful that the principles of law still apply. That where company officers operate in a manner that is unlawful as disregarding the right of creditors at a time when a company is unable to pay its debts as they fall due, or indeed, within certain period leading up to commencement of the liquidation, the appointment of an official liquidator offers potential remedies otherwise unavailable to creditors. These remedies are available to assist liquidators to achieve the best possible return to the creditors of the insolvent company.

Grant Thornton's firm of Insolvency Practitioners and Conyers law firm of legal advisers can assist creditors in pursuing those remedies. By appointing an official liquidator who has a statutory duty to consider these claims for the benefit of creditors, has the advantage of forensic capabilities, and has the requisite powers to rescind or avoid antecedent transactions a fair playing field and potential recoveries can be achieved for all stakeholders involved.

Conyers Contacts:

Ben Hobden
Partner
ben.hobden@conyers.com
+1 345 814 7366

Róisín Liddy-Murphy
Attorney
roisin.liddy-murphy@conyers.com
+1 345 814 7371

Grant Thornton Contacts:

Margot MacInnis
Managing Director
margot.macinnis@uk.gt.com
+1 345 769 7218

Prudence Pryce
Insolvency Manager
prudence.price@uk.gt.com
+1 345 769 7207