

Grand Court strikes out a creditor's winding up petition and comments on the relationship with arbitration clauses

Insights - 10/05/2021

Introduction

In the recent case of *Re Grand State Investments Limited*,^[1] the Grand Court of the Cayman Islands (**Grand Court**) struck-out a winding-up petition presented against Grand State Investments Limited (**Company**) by a shareholder claiming a debt (**Petitioner**) on the ground that the alleged debt was disputed on *bona fide* and substantial grounds. In addition, Mr Justice Parker went on to hold that, had the petition not been struck out, it would have been stayed anyway in favour of arbitration.

Background

The Company is incorporated in the Cayman Islands as the ultimate holding company for a corporate group engaged in the education sector in the PRC. The Petitioner invested in the Company via the purchase of Series C preferred shares (**Shares**) and, at the same time, it also entered into a shareholders' agreement (**SHA**) with the Company which is governed by Hong Kong law. The SHA provides that any disputes arising in connection with the terms of the SHA are to be resolved by arbitration administered by the Hong Kong International Arbitration Centre (**HKIAC**).

In September 2020, the Petitioner purported to redeem its Shares by serving a notice on the Company which requested payment of its redemption proceeds by 30 October 2020. However, the Company disputed its liability to pay those sums by that date because of a provision in the SHA allowing it to pay redemption proceeds from "time to time out of legally available funds" as and when such funds become available.^[2] In other words, the Company's position was that the requirement to satisfy a redemption request is not automatic (as is often the case) but rather conditional – and the condition for payment, namely the presence of legally available funds, was not satisfied here^[3].

The Petitioner served a statutory demand against the Company and, after 21 days had elapsed with no payment, presented a creditor's winding up petition (**Petition**) on the ground that the Company should be deemed insolvent and wound-up by the Grand Court due to non-payment of the statutory demand.^[4] The Company responded by applying to strike-out the Petition as an abuse of process on the basis that the alleged debt (being the claimed redemption sum) was *bona fide* disputed on substantial grounds. Alternatively, the Company also applied for an order that the Petition should be stayed in favour of the HKIAC arbitration in accordance with the terms of SHA.

Strike-out

As Mr Justice Parker noted, the law in the Cayman Islands on this point is well settled – where a debt which forms the subject matter of a winding up petition is genuinely disputed on substantial grounds, the general practice of the Grand Court is to strike it out or dismiss it. As has been confirmed by authorities such as *Parmalat Capital Finance Ltd v Food Holdings Ltd*^[5] and *Camulos Partners Offshore Ltd v Kathrein and Company*,^[6] the Cayman Courts will not permit petitioners to either use the threat of a winding up petition to force a company to pay a bona fide disputed debt or make improper use of the winding up jurisdiction to resolve an *inter partes* dispute.

In striking out the petition, Mr Justice Parker agreed with the Company that it was "plainly arguable" that the SHA did not require the Company to pay the redemption sum unless and until it had sufficient legally available funds (such funds not including any monies which were required for the Company's ordinary course of business). Further, the Company's obligation under the SHA to exercise all reasonable efforts in good faith to increase its legally available funds only applied to the extent that (i) the Company had the legal power to compel distributions from its subsidiaries; and (ii) the subsidiaries themselves had available funds beyond what they required for use in the ordinary course of business.

Faced with these contractual hurdles, the Petitioner sought to avoid the consequences of this construction of the SHA by pointing to a bank statement showing that the Company held some funds that exceeded the statutory minimum for serving a statutory demand under the Companies Act. The Petitioner argued that these were legally available funds which had not been paid to the Petitioner and, although the majority of the sums claimed made may be amenable to a dispute, the making of a winding up order was justified.

Mr Justice Parker rejected this contention, following the decision of the English High Court in *In re a Company (No. 003729 of 1982)*,^[7] on the basis that the Company had disputed the very existence of the debt rather than merely its quantum. In doing so, Mr Justice Parker also distinguished the approach to be taken when considering the existence of a *bona fide* dispute on substantial grounds from that to be taken on the issue of standing to present a petition.

Given the above findings, Mr Justice Parker found that the issues raised by the Company in challenging the alleged debt gave rise to a *bona fide* dispute on substantial grounds and, as a result, the Petition was struck out.

Stay in favour of arbitration

The Court also dealt with the alternative basis of the Company's application; the application for a stay given the presence of an agreement to refer disputes concerning the SHA to arbitration. Mr Justice Parker found that, had the Petition not been struck out, it would have been stayed in favour of arbitration.

In so doing, the Grand Court relied upon the approach taken by the Cayman Courts in decisions such as *Re Sphinx Group of Companies*[8] and *Re Times Property Holdings Ltd*,[9] confirming that the Court will ordinarily grant a stay of a winding up petition based on a disputed debt where the underlying dispute falls within the scope of an agreement to arbitrate. Importantly, however, Mr Justice Parker did confirm that the mere presence of a dispute will not be enough; instead the Grand Court will need to be satisfied as to the existence of a *bona fide* dispute on substantial grounds prior to being able to exercise its discretion to stay the Petition in favour of arbitration.

Against that background, the Grand Court confirmed that the starting point for the consideration of these issues should be respect for the parties' autonomy to choose a dispute resolution mechanism.[10] However, this alone would not be dispositive of the issue. The Grand Court will look at the circumstances of the case and determine whether, on the particular facts, a stay was appropriate.

In this case, Mr Justice Parker found that the following factors would have justified the grant of a stay in favour of arbitration had the petition not been struck out:

- i. there was a valid and operative arbitration agreement
- ii. arbitration had been commenced prior to the hearing of the strike-out application
- iii. the discrete issues to be determined in the arbitration were issues of foreign law (Hong Kong and PRC law) with which the Grand Court may not be familiar
- iv. certain disputed issues were not amenable to determination on the basis of affidavits or without cross-examination, and where certain key witnesses were non-English speakers, this presented some additional challenges if done in the Grand Court; but
- v. the above matters would not be issues in the context of the arbitration as it was to be conducted in Hong Kong; and
- vi. the language of the arbitration was to be Chinese

Accordingly, Mr Justice Parker considered that disputes in issue would be best decided by arbitrators familiar with Hong Kong law and fluent in both Chinese and English. That was all the more important where the relevant witnesses all spoke Chinese and a number of documents exhibited at the hearing had also been in Chinese.

Conclusion

The decision in *Grand State* is a reminder for redeeming shareholders to carefully review the contractual terms which govern the exercise of redemption rights before presenting a winding-up petition, or else risk having a petition struck out or stayed. Should that happen, adverse costs consequences will also follow.

This case also confirms that the Grand Court will respect arbitration agreements and not rush to invoke the winding-up jurisdiction when it would interfere with the parties' contractually agreed dispute resolution mechanism; provided that the dispute in question is not merely being raised by the company to avoid the inevitable.

Ogier acted for the Company in these proceedings.

[1] 28 April 2021, FSD 11/2021 (RPJ).

[2] The terms of the SHA and the Company's articles of association were identical in this respect.

[3] The Company also raised issues regarding the waiver, by the Petitioner, of its right to redeem. Given the Court's determination on the above issues, there was no need to deal with that issue.

[4] Section 92(d) of the Companies Act (2021 Revision).

[5] [2008] CILR 202.

[6] [2010] 1 CILR 303.

[7] [1984] 1 WLR 1090 at 1094 (Mervyn Davies J).

[8] Unreported, Cayman Islands Court of Appeal, 2 February 2016

[9] [2011] 1 CILR 223.

[10] See *Salford Estates (No 2) Limited v Altomart Limited* [2014] EWCA Civ 1575

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