Grand Court further develops insolvency test for Cayman Islands segregated portfolio companies

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By virtue of the special nature of Cayman Islands segregated portfolio companies, [1] where one portfolio of the company is in financial distress but the others (and their investors) remain unaffected, the Cayman Islands Companies Act (2022 Revision) provides for the appointment of a receiver to the relevant portfolio, without needing to wind up the company in its entirety. To engage the Court's jurisdiction to make a receivership order over a segregated portfolio, it must be "insolvent" within the meaning of 224(1) of the Companies Act. This raises the question: what's the appropriate test for insolvency to be applied by the Court?

In a recent decision, the Grand Court in *In the Matter of Green Asia Restructure Fund SPC*, [2] building on the earlier decision of Parker J in *Obelisk Fund SPC* [3] clarified that the section gives rise to a flexible variation of the balance sheet test.

Background

Applied Investment (Asia) Limited (the **Petitioner**) was the sole participating shareholder in portfolios managed by Green Asia Restructure Fund SPC. Having submitted redemption requests which went unpaid, it was also a redemption creditor. The Petitioner sought to appoint receivers over the segregated portfolio it had invested in on the basis that it was insolvent. [4]

The Law

For a receivership order to be made, section 224(1) of the Companies Act requires the Court to be satisfied that the segregated portfolio's assets "are or are likely to be insufficient to discharge the claims of creditors in respect of that segregated portfolio". The test is not on all fours either

with the classic formulation of the balance sheet test, or the traditional cash flow test applied in relation to the winding up of other Cayman Islands companies.

In *BNY v Eurosail*, [5] the Supreme Court held that the cash flow test is concerned with debts presently falling due and in the reasonably near future. The meaning of "reasonably near future" is fact sensitive and will depend especially on the nature of the company's business. In moving beyond the "reasonably near future", applying the cash flow test would become a much more speculative procedure. The Court in *BNY v Eurosail* observed that the only sensible option at that point is to compare present assets with present and future liabilities (the latter having taken into consideration contingencies and deferred payments); which is the balance sheet test.

Obelisk

The first detailed judicial consideration of section 224(1) was the 2021 decision in *Obelisk Fund*, where the petition was brought on the basis of an unsatisfied statutory demand. While the segregated portfolio had substantial illiquid assets, it did not have sufficient liquid assets to pay the debt which was the subject of the statutory demand.

The Petitioner contended that section 224(1) required the Court to apply the cash flow test, meaning that a finding of insolvency should be made on the basis of the unpaid demand. The Petitioner argued that a traditional balance sheet test would be unfair to creditors who do not have access to full information regarding the segregated portfolio's assets and could not therefore prove that the segregated portfolio's total liabilities outweighed its assets. Obelisk, on the other hand, contended that the balance sheet test should be applied and, as a result, the relevant portfolio was not insolvent because, despite not having enough cash to pay the statutory demand immediately, it did have sufficient illiquid assets to pay the debt in the longer term.

In *Obelisk*, the Court ultimately held that section 224(1) was, on a plain reading of the statute, a balance sheet test. It required the court to determine whether the segregated portfolio's assets outweighed its liabilities. However, the Court also acknowledged that the balance sheet test poses practical difficulties for creditors, for the reasons given by the Petitioner and that, in fact, the section actually provided for a more flexible version of the traditional balance sheet test.

Parker J considered that section 224(1) provided two alternative grounds to engage the court's jurisdiction to make a receivership order:

- the first is if the assets of the segregated portfolio **are** insufficient to meet its liabilities
- the second is if the assets of the segregated portfolio **are likely to be** insufficient to meet its liabilities

The second formulation, in Parker J's opinion, meant that if it could be shown that a relatively modest sum had been demanded, but had not been paid, then the starting point would be that

the petitioner could say "the assets, presently realisable or liquid, are insufficient to discharge the claim."

Green Asia SPC

Justice Kawaley agreed with Parker J's broad conceptual approach in *Obelisk*. He went on to say: "The phrases 'are' and 'are likely to be' were not simply different ways of expressing the same thing. He thought, properly interpreted, what that section means is if a creditor could prove either (a) it is probable that a deficiency exists (the segregated portfolio's assets are insufficient to meet its liabilities); or (b) the evidence establishes a risk of a deficiency so cogent and real that a receiver should prima facie be appointed in any event.

Kawaley J added two further justifications in support of a more flexible balance sheet test than would otherwise apply in the winding up context:

1. a receivership order was less drastic than a winding up order because a segregated portfolio is by design easier to get in and out of than a limited company

2. the risk of an overly flexible balance sheet test is counterbalanced by the fact that a creditor is not, if the test is met, entitled to the winding up order as of right. The Court must also consider the sufficiency of assets against the "claims of creditors" (ie the overall financial state of the portfolio has to be considered). And the receivership order must achieve the statutory purpose set out in section 225(1), ie the orderly closing down of its business and the distribution of its assets

Conclusion

Unlike the cash flow test that is ordinarily applied to determine whether a company ought to be wound up on the grounds of insolvency, the test for insolvency of a segregated portfolio under section 224(1) is primarily a balance sheet test that requires the Court to consider whether the segregated portfolio's assets outweigh its liabilities. However, the section also provides room for flexibility, such that an unpaid demand for payment is likely be effective proof of a prima facie case of insolvency which can be grounds for a finding of insolvency if the segregated portfolio is unable to offer evidence to prove it will be able to pay the debt in the reasonably near future. The approach adopted by the Court in both *Obelisk* and *Green Asia Restructure Fund* demonstrate the pragmatic approach adopted by the Cayman Court to corporate insolvency, seeking to balance the interests of both shareholders and creditors.

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[1] For more information about Cayman Islands SPCs, read our briefing: Insolvency and restructuring: Cayman Islands Segregated Portfolio Companies

[2] (FSD 112 and 113 of 2022) (IKJ) (6 July 2022)

[3] *Re Obelisk Global Fund SPC* (Unreported, 12 August 2021, FSD 87 of 2021, RPJ)

[4] Notably, it could not do so simply on the basis that it held the entire economic interest in the SPC because 224(1) appears to require the court to make a finding of insolvency, even if it is the creditors or directors who bring the petition

[5] *BNY Corporate Trustee Services Ltd and others v Eurosail-UK 2007-3BL PLC and others* [2013] UKSC 28 (9 May 2013)

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Meet the Author

Gemma Bellfield (nee Lardner)

Partner

Cayman Islands

E: gemma.bellfield@ogier.com

T: +1 345 815 1880

Key Contacts

Max Galt

Associate

Cayman Islands

E: max.galt@ogier.com

T: +1 345 815 1830

Jennifer Fox

Partner

Cayman Islands

E: jennifer.fox@ogier.com

T: +1 345 815 1879

Oliver Payne □□□

Partner □□□

Hong Kong

E: oliver.payne@ogier.com

T: +852 3656 6044

Jeremy Snead

Partner

London

Cayman Islands

British Virgin Islands

E: jeremy.snead@ogier.com

T: +44 20 3835 9470

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