Harbinger of Change to the Loss of Substratum Test Applicable to Cayman Islands Companies

In *Re Harbinger Class PE Holdings (Cayman) Ltd* [1], a judgment of Clifford J handed down on 10 November 2015, the Grand Court of the Cayman Islands clarified two matters concerning petitions to wind up a company on the just and equitable ground on the basis it has lost its substratum:

- The applicable test for whether there has been a loss of substratum, in petitions against companies other than open-ended mutual funds, is whether it is *impossible* (as opposed to merely impractical) for the company to achieve the object for which it was formed; and
- In applying that test to a company with an unrestricted objects clause in its memorandum of association, the court must look beyond the clause and ascertain, on the particular evidence, what is the principal or main object of the company in line with the reasonable expectations of its participating shareholders.

Background

Harbinger Class PE Holdings (Cayman) Ltd ("**the Company**") was a special purpose vehicle established in December 2008 as part of a credit crunch restructuring of a Master-Feeder fund structure following losses arising from the collapse of Lehman Brothers. Investors in the Feeder received shares in the Company by way of an *in specie* redemption of their shares in the Feeder. A supplement to the Offering Memorandum, which explained the synthetic side-pocket type of arrangement, stated an intention to realise the illiquid assets by the end of 2010. Although substantial realisations and distributions were made, the process was not complete.

An investor presented a petition to wind up the Company on the "just and equitable" ground [2], arguing that there had been a loss of substratum. The petition was dismissed on jurisdictional grounds because it was held that there was no loss of substratum.

Test for loss of substratum

The appropriate test for determining whether there had been a loss of substratum was central to the case. The enquiry comprised two parts:

(i) Does the object for which the company was formed need to become impossible or merely impracticable?

(ii) Is the company's purpose to be determined solely by reference to its constitutional documents?

(i) Impossibility / Impracticability

The Judge reviewed the authorities and found that:

- A long line of English authority pointed to 'impossibility' as the applicable test. Winding up petitions had typically only been granted for loss of substratum where a company was formed for a particular purpose or activity which was either abandoned, came to an end, or was otherwise impossible to pursue.
- Recent Cayman case law at first instance, starting with *In the Matter of Belmont Asset Based Lending Limited* [3], departed from the English approach and applied a less stringent test of whether it had become *"impractical, if not actually impossible"* to carry out the purpose of the company. *Belmont* and the cases in which it was followed all concerned open-ended corporate mutual funds.
- The *Belmont* test was considered but not followed by Bannister J in the BVI, with the English test being preferred. Bannister J considered that there was no basis for open-ended corporate mutual funds to be treated differently and rejected the concepts of practicality and viability favoured in *Belmont* as too uncertain.

Clifford J followed the English authorities and distinguished Jones J's decision in *Belmont* on the basis that it expressly related to open-ended corporate mutual funds, which the Company was not [4]. However, it may be inferred from the judgment that Clifford J considers *Belmont* to have applied the incorrect test.

(ii) Determining the Principal or Main Object

There remained the issue of how to ascertain the purpose of a company. This was of interest in *Harbinger* because the Company had an unrestricted objects clause in its memorandum of association, and therefore was capable of carrying out any object not prohibited by law.

The Company argued that the Court could look no further than the objects clause, which was unrestricted, and was therefore bound to find that the principal or main object had not become impossible.

Clifford J rejected the submission and held that, in the case of a wholly general objects clause, the Court must look beyond it and ascertain the principal or main object for which the Company was formed by reference to the evidence of participating shareholders' reasonable expectations [5].

Decision

In applying the test, the Judge held that the principal or main object of the Company had not become impossible [6].

The Judge found that the petitioner had confused the roles of the Company and of the Master Fund. It was not the object of the Company to realise the assets in the Master Fund and to return proceeds to investors. Instead, the object of the Company was limited to holding the relevant shares issued by the Master Fund and receiving through the redemption of those shares the net cash flow from the realisation by the Master Fund of its assets, for onward payment to the Company's own shareholders. On that basis, the object of the Company had not become impossible.

Comment

Harbinger creates a split in the applicable test in this jurisdiction when determining if a company has lost its substratum for the purpose of a winding up petition on the just and equitable ground. Open-ended mutual corporate funds may be deemed to have lost their substratum, and therefore be liable to be wound up, if the conduct of their business has become impractical or ceased to be viable, whereas the conventional test of impossibility will apply to other businesses.

It is questionable whether two separate tests for loss of substratum are warranted. With two lines of authority of the Grand Court applying different standards, it is now for the Cayman Islands Court of Appeal to decide the applicable test when the opportunity arises, or to confirm that a different test should apply to open-ended corporate mutual funds.

As to the determination of a company's object, the mandatory wider search for the principal or main object of the company will apply in circumstances where the company has a wholly general objects clause. This may lead to a higher evidential cost to proving loss of substratum in such cases. What is not clear is whether, for companies with a specific objects clause, it will be open to those resisting the petition to argue that the principal or main object was in fact something other than what it appeared to be from the company's constitution.

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[1] Unreported, dated 10 November 2015.
[2] Companies Law (2013 Revision), Section 92(e)
[3] [2010] 1 CILR 83 per Jones J
[4] paras 52-53, 57-58
[5] para 65
[6] paras 83-84

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