

# Validation orders under section 99 of the Companies Law – explained by the Cayman Islands Court of Appeal

The Cayman Islands Court of Appeal has clarified the purpose and effect of section 99 of the Companies Law (the “**Law**”) and the principles to be applied in granting validation orders in an important decision handed down earlier this year: *Tianrui (International) Holding Company Limited (“Tianrui”) v China Shanshui Cement Group Limited* (the “**Company**”).

## Section 99

Section 99 of the Law provides:

*When a winding up order is made, any disposition of the company’s property and any transfer of shares or alteration in the status of the company’s members made after the commencement of the winding up is, unless the Court otherwise orders, void.*

The section has retrospective effect because the commencement of a winding-up is treated as the date a petition is presented, rather than the date when a winding-up order is made. Accordingly, between the presentation of a petition and its resolution (the “twilight period”), any transaction will be avoided if a winding up order is made, unless the Grand Court of the Cayman Islands (the “**Court**”) validates the transaction under section 99.

The presentation of a petition can have a damaging effect, particularly on companies that are trading, due to uncertainty in the twilight period. A validation order takes away that uncertainty and enables companies to continue to operate in the ordinary course of their business prior to the hearing of the petition, which could be many months later.

In past decisions, there have been some inconsistencies in approach and/or distinctions drawn between insolvent and solvent companies when deciding whether to grant a validation order under section 99. The Court of Appeal has now clearly laid out the principles applicable to the granting of a validation order in respect of both scenarios to ensure consistency with the purpose of the section.

## Background

The Company is a holding company whose subsidiary is amongst the largest of the cement producers in the People’s Republic of China (“**PRC**”). Its shares were listed on the Hong Kong Stock Exchange. In 2014, the PRC

prohibited expansion of the domestic cement industry to tackle serious production over-capacity, which meant that expansion could only be achieved by merging with existing producers. This resulted in major shareholders of the Company (who are also its direct competitors) seeking to expand their holding and becoming involved in what has been described as a bitter take-over battle for control of the Company.

Tianrui, one such major shareholder, presented a just and equitable winding up petition against the Company alleging that Asia Cement Corporation (“**ACC**”) had acted improperly in concert with China National Building Materials Co Ltd. (“**CNBM**”) (both rival shareholders who were at the time in control of the board of the Company) to dilute Tianrui’s shareholding to try and squeeze it out. Tianrui alleged that this was achieved by the directors improperly exercising their powers to issue bonds (which were subsequently converted into shares) to parties related to ACC and CNBM.

In March 2019, the Company sought validation of eighteen proposed transfers of shares (representing 43.96% of the Company’s issued share capital and including those that were the subject-matter of the petition) to the HKSCC to facilitate the trading of those shares through an electronic clearing and settlement system for the public stock market in Hong Kong (known as “**CCASS**”). In order to trade using CCASS, shareholders must transfer their legal title to HKSCC (which acts as a common nominee), prior to depositing their shares into the system. CCASS indicated that before it would accept the deposit of shares, it required the Cayman Court to validate the transfer of legal title to HKSCC.

Tianrui submitted that by virtue of sections 45 and 54 of the Hong Kong Securities and Futures Ordinance, the proposed transactions should not be validated because it would make it impossible to unwind those transactions. It would, therefore, cause serious and irreversible consequences and would prejudice the outcome of the petition because it would be impossible to unwind the improper and dilutive share issue that Tianrui seeks to impugn as part of the conspiracy to dilute its own shareholding if the petition is upheld.

## Grand Court Decision<sup>[1]</sup>

In the first instance, the Honourable Justice Mangatal, ordered that the transfers should not be avoided by the provisions of section 99. Mangatal J accepted the Company’s case for validation: that it was a response to CCASS’s request and that it wished to reduce the illiquidity of its shares, which the Judge thought (applying the well-known test for validation set out in *Burton v Deakin Ltd* [1977] 1 WLR 309) were reasons which an intelligent and honest director could reasonably hold in good faith and had a clear commercial basis. Further, she found that Tianrui had not provided any compelling evidence that the transfers were detrimental to the Company.

The Judge also held that, since the shares were fully paid up, the transfers did not run afoul of the rationale of section 99, which she considered was to prevent shareholders from evading liability by transferring partly paid shares to a man of straw after winding up has commenced.

## Court of Appeal Decision

The Court of Appeal overturned the decision of Mangatal J. It accepted Tianrui’s contention that the Judge misunderstood the purpose of section 99 and failed to identify the correct approach to validation under that

section.

Moses JA, delivering a unanimous decision of the Court of Appeal, confirmed that the fundamental purpose of section 99 is to maintain the status quo between presentation and resolution of the winding up petition so as to render effective the section's retrospective function. He said (at paragraph 41):

*"... as a matter of principle, a court, in every case, must satisfy itself that any order it makes does not undermine or frustrate the maintenance of the status quo pending resolution of the petition, and that, on the contrary, the order should be made in furtherance of that objective. This principle should not alter according to the particular circumstance of the case. Of course, its application will vary from case to case."*

Second, the Court of Appeal found that the section "*applied to all companies, the subject of a compulsory winding up, whether the company is solvent or not, whether it is a trading company or undertakes some other business, and whether the winding up is on the grounds of insolvency or on just and equitable grounds.*"

In applying these principles, the Court of Appeal made the following important observations:

1. It is dangerous to assume that a court may be relieved of the responsibility of careful scrutiny and caution merely because the company is solvent. The court can make no assumptions as to the propriety of the proposals of the directors and will need to be satisfied that they are consistent with the purposes of the section and for the benefit of the company and those interested in the value of its assets.
2. The Court of Appeal adopted the submission of Tianrui that: "*just as in the case of a creditor's petition validation will not be allowed to undermine the purpose of a winding up (i.e. pari passu distribution), in a just and equitable petition a validation order should not undermine the objective of stopping or reversing oppressive conduct.*"
3. Careful scrutiny is needed not just to protect creditors in an insolvency petition but also contributories at a stage when no-one can say whether the petition in respect of a solvent company will succeed or not.

As the transfer of legal title from a shareholder to HKSCC fell squarely within section 99, the Court only ought to have made a validation order in circumstances which assisted in preserving the status quo and which did not frustrate the purpose of section 99. This required a careful analysis as to the reason why the shares were to be deposited into CCASS and, above all, consideration as to whether validating such a transaction would impede or frustrate the purpose of section 99, as Tianrui contended. The Court of Appeal found that Mangatal J mistakenly neither questioned nor scrutinised the Company's case for validation.

The Court of Appeal undertook the task of scrutinising the Company's proposal itself and found:

1. No explanation was given as to why the shareholders wanted to deposit their shares into CCASS at a time when it seemed unlikely they would want to sell their shares;

2. There was no evidence as to why the Company which is a holding company, the parent of operating subsidiaries, wanted to raise finance;
3. There was no reasonable explanation for the transaction other than that proffered by Tianrui, namely that the deposit was intended to baulk the unwinding of those transactions and any future restoration of the status quo, should the Petition be successful; and
4. The transactions proposed were not made in the ordinary course of business: the Company's business is in holding interests in subsidiaries, it is not in the business of trading in its own shares.

The Court of Appeal concluded that the Judge made material errors of law leading her to a failure to consider relevant evidence and to make necessary assessments of that evidence. Accordingly, her exercise of evaluative judgment could not stand, the order was reversed and the Court of Appeal refused to make a validation order.

## Conclusion

This is a welcome clarification from the Court of Appeal confirming that the fundamental purpose of section 99 (whether the company is solvent or insolvent) is to maintain the status quo and all applications made for validation under this section need to be carefully scrutinised by the Court to ensure consistency with that purpose.

*This article constitutes general guidance and commentary; it should not be relied upon as advice in relation to any specific situation.*

[1] Campbells' note on the first instance decision can be found here: <https://www.campbellslegal.com/articles/guidance-from-cayman-on-validation-orders-facilitating-the-transfer-of-shares-on-the-hong-kong-stock-exchange-and-variation-of-orders-entered-by-consent-5208/>



**Jane Hale**  
Partner



**Guy Manning**  
Partner

+852 3708 3026      +1 345 914 5868  
[jhale@campbellslegal.com](mailto:jhale@campbellslegal.com)   [gmanning@campbellslegal.com](mailto:gmanning@campbellslegal.com)