Cayman Court clarifies the function and role of the Liquidation Committee in a Cayman liquidation

In a recent judgment in the liquidation of Herald Fund SPC, an insolvent Madoff feeder fund, the Grand Court addressed the extent to which official liquidators are required to seek the approval or tacit support of the Liquidation Committee when defining the scope of their operational functions and, consequentially, incurring liquidation costs and expenses.

The Court held that it is not the role of the Liquidation Committee to micro-manage litigation brought by liquidators which it said was only likely to undermine the efficacy of recovery actions. The Liquidation Committee's true statutory function is instead limited to high-level approval of work-streams coupled with practical commercial assessments of regular budgets and fee reports. The Court commented that the working relationship between the liquidators and the Liquidation Committee should be effective and cordial and informed by a spirit of trust and confidence between the individuals involved, with the objective of achieving a consensus driven approach for the benefit of all stakeholders.

This advisory provides an overview of the function and role of the Liquidation Committee in the liquidation of a Cayman Islands company and highlights the key points arising out of the Court's recent judgment.

Function of a Liquidation Committee

The statutory framework for the winding up of companies is comprised of Part V of the Companies Act (2021 Revision) and the Companies Winding Up Rules, 2018 ("**CWR**").

Where a company is being wound up compulsorily by order of the Court or under the supervision of the Court, the Court may (and invariably does) appoint one or more individuals to act as official liquidators for the purpose of conducting the proceedings in winding up the company and assisting the Court. The official liquidator acts as an officer of the Court and remains under its supervision and control. In exercising its powers, the Court will consider how best to serve the interests of the stakeholders.[1]

The statutory function and powers of official liquidators are set out in section 110 of the Companies Act with the primary function being to collect, realise and distribute the assets of the company to its creditors and, if there is a surplus, to the persons entitled to it and to report to the company's creditors and contributories upon the affairs of the company and the manner in which it has been wound up.

The exercise by the liquidator of the powers conferred by section 110 of the Companies Act is subject to the

control of the Court and sub-section 110(3) provides that any creditor or contributory may apply to the Court with respect to the exercise or proposed exercise of such powers. Whilst the Court retains an inherent discretion on any issue arising in the liquidation, section 115 of the Companies Act provides that the Court shall have regard to (but not be bound by) the wishes of the creditors or contributories on all matters relating to the winding up.

It is in this context that the CWR provide for the establishment and defines the statutory function of a Liquidation Committee ("**LC**") to act as a consultative body and sounding board for the liquidators in respect of any important decision in the liquidation.

The LC's views are intended to be representative of those who have an economic interest in the liquidation, consistent with the general principle of company law that those interested in a company are generally the best judges of where their own interests lie.

In *Re Herald SPC* the Court held that the combined effect of section 110(3) of the Companies Act and the statutory role of the LC was that the LC has no positive legal right to approve what a liquidator proposes to do, whether in relation to litigation strategy or otherwise, but the convention is for an official liquidator to seek LC approval for all significant liquidation decisions and/or all significant incurring of costs.

The formation of a Liquidation Committee

Except where the court agrees to dispense with the requirement, an LC is required to be established in every official liquidation of a company. The Court also has the power to direct that an LC be established in a provisional liquidation.

Where the liquidators have determined that the company should be regarded as insolvent, it is the creditors who are deemed to have the economic interest in the liquidation and as such the LC is elected at the first meeting of creditors in the liquidation and is comprised of between three and five creditors. Any creditor, other than one whose debt is fully secured, is eligible to be a member of the LC provided that they have lodged a proof of debt which has not been wholly disallowed for voting purposes or wholly rejected by the liquidators.

Where the company is regarded as solvent then the LC is elected at the first meeting of contributories and is comprised of between three and five contributories. Where the shares are held by a custodian or clearing house, the beneficial owner of the shares may be elected provided that the custodian certifies in writing that he holds the shares for the beneficial owner.

In the case of a company determined by the liquidators to be of doubtful solvency, a hybrid approach is adopted with the LC comprising not less than three and not more than six members, of whom a majority must be creditors with at least one contributory.

The election of members to the LC is a matter for those present and voting at the meeting of creditors or contributories. As resolutions at creditors and contributories' meetings are passed by a majority (in value) of those present and voting, it often follows that the largest creditors or contributories are elected to the LC, consistent with those individuals having the greatest exposure to and interest in the liquidation.

LC members act in a fiduciary capacity

Members of the LC occupy a representative and fiduciary position in relation to the estate and to those interested in the estate. The members owe a duty to discharge their function in an objective manner having regard to what they consider to be the best interests of unsecured creditors as a whole (or contributories in the case of a solvent liquidation), not their own personal interests.[2]

The fundamental duty of a fiduciary is loyalty and fidelity and LC members have a duty to act bona fide (i.e. in good faith) and in what they consider to be the best interest of stakeholders. LC members are required to disclose any conflict or potential conflict of interest and conflicts are typically managed through the establishment of a sub-committee of non-conflicted members to consult with the liquidators on those particular issues.

The liquidator's duty to report to the LC

The Court held in *Re Herald SPC* that the primary express obligation of the liquidator under CWR Order 9, rule 4 is to report to the LC on all matters which appear to the liquidator to be of concern to the LC, or which the members themselves have identified as being of concern, with respect to the winding up and that the primary implied obligation of the liquidator is to consult with the LC in respect of such issues.

The LC is expected to form a judgment and express an informed view to the liquidator about the matters in issue and accordingly the liquidators are required to comply with all reasonable requests for information from the LC unless it appears to the liquidator that the request is frivolous or unreasonable, that the cost of complying with the request would be excessive having regard to the relative importance of the information sought or where there are insufficient assets available to enable the liquidator to comply with the request and recover his costs of doing so.

Proceedings at LC meetings

At meetings of the LC, each committee member has one vote regardless of the size of their interest and resolutions are passed by a simple majority of those present and voting. For this reason, it is preferable (but not mandatory) for the LC to be comprised of an odd number of members so as to avoid the potential for deadlock.

The purpose of the LC voting on resolutions is to establish a consensus of the committee on the issue before it. However, the LC does not have an express or implied power to bind an official liquidator by its decisions and it has no right of veto.

The liquidator acts as chairman of the meeting unless the members resolve that one of their number shall act as chairman. The chairman, acting in that capacity, does not have a vote or a casting vote. The chairman's primary duties are to preserve order, to ensure that the business of the meeting is conducted in a proper and efficient manner, to ensure that all opinions are given a fair hearing as far as practicable, to accept all legitimate resolutions and amendments and to ascertain the views of the meeting on the questions under consideration.

The right to speak at meetings generally arises by virtue of the right to vote. However, it is not uncommon for committee members to seek permission for additional representatives or for their own legal counsel to attend

meetings in an observer capacity at their own cost. In the event that any objection is raised on any issue relating to the conduct of the meeting, the chairman should put the matter to a vote of those present and entitled to vote and abide by the decision of the meeting acting as a simple majority in the absence of unanimity.

The LC's right to engage legal counsel

The LC is entitled as of right to engage legal counsel to advise it as a committee either generally or in respect of any specific matter arising in connection with the liquidation, with the legal fees and expenses reasonably and properly incurred being paid out of the assets of the company as an expense of the liquidation.

However, any time spent costs incurred by LC members acting as such or any legal fees incurred by members individually (whether in respect of LC matters or otherwise) are not recoverable out of the assets of the company with the effect that LC members bear their own costs of participating in the LC.

Sanction applications

Section 110 of the Companies Act refers to a liquidator's powers under Part I of Schedule 3 which are exercisable with sanction of the Court and powers under Part II of Schedule 3 which are exercisable with or without that sanction.

In *Re Herald SPC* the Court held that because the jurisdiction to sanction the exercise of liquidators' powers is vested in the Court, liquidators should ordinarily seek prospective Court sanction for any significant actions which the LC either clearly does not support or clearly opposes.

Any sanction application made by the liquidators must be served on each member of the LC or, where appointed, on counsel to the LC and heard on not less than 4 clear days' notice. The LC is entitled to engage legal counsel to appear on its behalf at the hearing of any sanction application.

Approval of the Liquidator's remuneration

Pursuant to Regulations 10 and 12 of the Insolvency Practitioners Regulations, 2018 ("**Regulations**"), before an official liquidator makes an application to the Court for the approval of his remuneration he is required to seek the LC's approval of the basis of his remuneration and the amount of the remuneration for which he intends to seek the Court's approval.

The obligation on the liquidators is to prepare a report and accounts in accordance with the Regulations containing all the information reasonably required to enable a creditor or contributory to make an informed decision about the reasonableness of the remuneration and to seek the LC's approval before making an application to Court.

In *Re Herald SPC* the Court held that by necessary implication the statutory scheme of the Regulations enable the Court to place considerable reliance on the commercial judgment of the LC where it has approved the liquidators' fees and conversely the Court is required to scrutinise a remuneration application far more closely when the LC has declined to approve the fees. Where the approval of the LC is not forthcoming it is the

liquidators who bear the burden of proving that the remuneration sought is reasonable and justified.

The Court held that the LC's sole express statutory function in relation to the approval of fees is to assess the reasonableness of a liquidator's fees. In terms of the breadth of the LC's "reasonableness" assessment jurisdiction, the Court held that such an assessment may take in to account the reasonableness of the proposed exercise of powers, including an evaluation of whether it was useful to take certain steps at all. However, ordinarily a fee approval application should not be the context in which the Court is retrospectively invited to approve high-level policy or operational strategic decisions made by official liquidators.

The reasonableness of the fees should, in the ordinary case, be determined by reference to cost incurred in relation to work-streams the general pursuit of which has been informally approved by the LC or formally approved by the Court. The Court will only impugn an operational strategic decision made by the liquidators in furtherance of a legitimate liquidation purpose at the hearing of a fee application where the decision taken can fairly be said not to have been rational.

The Court held that the decision to incur the fees would not be rational if the work done by the liquidators was either not reasonable in the circumstances, not necessary or achieved no useful result. The Court commented that 21st century professional liquidators have a vested commercial interest in demonstrating their ability to meet the expectations of their stakeholders and to achieve commercially palatable practical results.

Commentary

Liquidators and stakeholders share a common primary objective which is to maximise returns to stakeholders. Occasionally, and in particular where complex issues arise in the liquidation or where recoveries are uncertain, a divergence of views can arise as to whether a particular step to be taken in the liquidation is likely to achieve the primary objective by reference to a cost-benefit analysis.

The liquidators are required to consult with the LC on such issues on the basis that the LC is a representative body of those that have the economic interest in the liquidation and those interested in a company are generally the best judges of where their own interests lie. However, official liquidators are highly experienced licensed insolvency practitioners who are expected to exercise their commercial judgment, based on their expertise and experience, to maximize recoveries for all stakeholders. It is the liquidators who the Court appoints to conduct the liquidation, not the LC.

Whilst the LC plays an important consultative role and the Court will give weight to its view, it is not the role of the LC to micro-manage the liquidation and it is the Court alone who has the power to supervise and sanction the exercise by the liquidators of their statutory powers.

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Islands companies and partnerships.

Notable recent instructions include:

- Advising the joint provisional liquidators of Luckin Coffee Inc. in connection with the restructuring of approximately US$1bn of debt, following a widely publicised fraud and delisting.
- Acting for the joint provisional and official liquidators of ABRAAJ Investment Management Limited, the investment manager of the Abraaj group. Prior to its collapse in 2018, Abraaj had been the largest private equity firm operating in emerging markets, with some 40 underlying funds, over 600 investors, and $14bn of AUM at its peak.
- Advising the Liquidation Committee of SAAD Investments Company Limited, a liquidation involving the longest trial in Cayman legal history.

Should you have any queries or require advice on issues relating to litigation, insolvency or restructuring in the Cayman Islands then please contact us directly.

In the matter of Saad Investment and Finance Company Limited #5 [2010 (2) CILR 63]
In re Bulmer, ex p. Greaves, which was cited with approval by the Chief Justice in In the matter of Saad Investment and Finance Company Limited #5 [2010 (2) CILR 63]

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