The International Comparative Legal Guide to:

Corporate Recovery & Insolvency 2017

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A practical cross-border insight into corporate recovery and insolvency work

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Editorial Chapter:

General Chapters:

Country Question and Answer Chapters:

Cayman Islands

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1 Overview

1.1 Where would you place your jurisdiction on the spectrum of debtor to creditor-friendly jurisdictions?

The Cayman Islands has traditionally been regarded as a creditor-friendly jurisdiction and that remains the case. Creditors are treated equally irrespective of where they are domiciled.

1.2 Does the legislative framework in your jurisdiction allow for informal work-outs, as well as formal restructuring and insolvency proceedings, and are each of these used in practice?

Informal work-outs are not addressed in the legislative framework, but they are used in practice when there is requisite support from affected stakeholders. Formal restructuring and insolvency proceedings are provided for in the Companies Law and are employed frequently. Schemes of arrangement are common, often combined with a provisional liquidation in order to obtain an automatic stay. The scheme may be promoted by the provisional liquidators, or by the management with the liquidators having a supervisory role in what are known as "light touch" provisional liquidations. Occasionally a Cayman provisional liquidation is used to facilitate an overseas restructuring process without a Cayman scheme of arrangement. Restructuring and insolvency proceedings are addressed in more detail below in sections 3 and 4 respectively.

2 Key Issues to Consider When the Company is in Financial Difficulties

2.1 What duties and potential liabilities should the directors/managers have regard to when managing a company in financial difficulties? Is there a specific point at which a company must enter a restructuring or insolvency process?

As a general principle of Cayman Islands law, directors' duties are owed to the company, rather than directly to shareholders or creditors. A number of duties might be engaged in circumstances of financial difficulty, but the fiduciary duty to act in the best interests of the company will always be relevant. What is meant by the best interests of the company in times of financial difficulty was considered in *Prospect Properties v McNeill* [1990-91 CILR 171]. In *Prospect Properties* the Grand Court of the Cayman Islands (the "**Grand Court**" or the "**Court**"), following the well-known line of English authorities, held that where a company is insolvent or of doubtful solvency, the directors' duty to act in the best interests of the company requires them to have regard to the interests of its creditors. It is in the interest of the creditors to be paid, and it is in the interest of the company to be safeguarded against being put in a position where it is unable to pay. Although there is no prescribed statutory point at which a company must enter a restructuring or insolvency process, directors can be made personally liable to the company for any losses which they cause to the company if they act in breach of that duty; an example of this might be incurring additional liabilities when they knew or should have known that there was no reasonable prospect of the company avoiding insolvent liquidation.

2.2 Which other stakeholders may influence the company's situation? Are there any restrictions on the action that they can take against the company?

As set out below, formal insolvency proceedings can be instigated by a company's creditors or contributories (among others). Their right to present a winding up petition is, however, subject to any contractually binding non-petition clauses and, in the case of a contributory, to the contributory having either inherited or been allotted its shares, or having been registered as their holder for at least six months.

2.3 In what circumstances are transactions entered into by a company in financial difficulties at risk of challenge? What remedies are available?

The principal applicable statutory provisions are sections 99 (avoidance of property dispositions), 145 (voidable preference), 146 (avoidance of dispositions at an undervalue) and 147 (fraudulent trading) of the Companies Law.

Section 99 (avoidance of property dispositions) provides that any dispositions of a company's property (or transfers of its shares) made after the deemed commencement of the winding up will be void in the event that a winding up order is subsequently made, unless validated by the court. The liquidator is entitled to apply for appropriate relief to require the repayment of the funds or the return of the asset.

Pursuant to section 145 (voidable preference), any payment or disposal of property to a creditor constitutes a voidable preference if:

- it occurs in the six months before the deemed commencement of the company's liquidation and at a time when it is unable to pay its debts; and
- the dominant intention of the company's directors was to give the applicable creditor a preference over other creditors.

A payment or disposition is deemed to have been made to give the creditor a preference where the creditor has the ability to control the company or exercise significant influence over it in making financial and operating decisions.

If a payment or disposition is set aside as a preference then it is void and the creditor will be required, on application by the liquidator, to return the payment or asset and prove (claim) in the liquidation for the amount of its claim.

Section 146 (avoidance of dispositions at an undervalue) provides that transactions in which property is disposed of at an undervalue with the intention of wilfully defeating an obligation owed to a creditor are voidable on application of the liquidator. This is subject to the application being brought within six years of the disposal. If a transferee has not acted in bad faith then although the disposition will be set aside, the transferee's pre-existing rights and claims will be preserved, and it will be entitled to a charge over the property securing the amount of costs which it properly incurs defending the proceedings.

If the business of a company was carried on with intent to defraud creditors or for any fraudulent purpose then, pursuant to section 147 (fraudulent trading), a liquidator may apply for an order requiring any persons who were knowingly parties to such conduct to make such contributions to the company's assets as the court thinks proper.

Lastly, transactions made by a company in financial difficulty and in breach of the directors' fiduciary duties may also be vulnerable to claims based on dishonest assistance or knowing receipt.

3 Restructuring Options

3.1 Is it possible to implement an informal work-out in your jurisdiction?

It is possible to implement informal work-outs in the Cayman Islands, provided that they are supported by the requisite stakeholders.

3.2 What formal rescue procedures are available in your jurisdiction to restructure the liabilities of distressed companies? Are debt-for-equity swaps and pre-packaged sales possible?

The principal mechanism used to restructure a company's liabilities is a scheme of arrangement between the company and its creditors or members, or classes of creditors or members, pursuant to section 86 of the Companies Law. If a scheme is approved by more than 50% by number and 75% by value of those attending and voting in each class, and is subsequently sanctioned by the Grand Court, it will bind all scheme participants (including any dissentient minority) and compromise their rights in accordance with the scheme terms.

Schemes can be promoted by the management outside of any insolvency process, but they are commonly combined with the presentation of a winding up petition and the appointment of provisional liquidators, in order to obtain the benefit of an automatic stay of actions against the company while the scheme process is undertaken. A scheme implemented during a provisional liquidation may still be promoted by the directors with the provisional liquidators merely having a supervisory role (in what are known as "light touch" provisional liquidations), or the provisional liquidators can temporarily displace the directors in order to promote the scheme. If the scheme is sanctioned by the Grand Court, then typically the winding up petition would be dismissed, the provisional liquidators would be discharged, and the restructured company would be returned to the full control of its management.

In some instances, restructurings have been implemented without a scheme of arrangement, by using a Cayman provisional liquidation to obtain an automatic stay and to facilitate and give effect to an overseas restructuring process.

Debt-for-equity swaps are a common feature of Cayman schemes. Pre-packaged sales are also possible, but are less common in practice.

3.3 What are the criteria for entry into each restructuring procedure?

Schemes of arrangement involve three main stages:

- an application for orders convening the scheme meetings (at which the Grand Court will principally be concerned with issues of class composition, any jurisdictional or similar issues, and the adequacy of the scheme documentation and notice);
- the scheme meetings (at which the scheme will require the approval of a majority in number representing not less than 75% by value of those present and voting in each class meeting); and
- a hearing to sanction the scheme (at which the Grand Court will principally be concerned with compliance with the convening orders, whether the majority fairly represent the class, and whether the arrangement, having regard to the scheme comparator, is such that an intelligent and honest man, who is a member of the class concerned and is acting in his own interest, might reasonably approve it).

The criteria for entry into provisional liquidation are addressed in question 4.1 below.

3.4 Who manages each process? Is there any court involvement?

The directors remain in control of the company if the scheme is proposed outside of liquidation, and the Grand Court is involved in ordering the convening of the scheme meetings and sanctioning the scheme (i.e., stages 1 and 3 above).

If the scheme is promoted within a provisional liquidation then the management of the scheme process will depend on the terms of the order appointing the provisional liquidators. In some cases, the provisional liquidators will only be given the powers necessary to supervise the directors' promotion and implementation of the scheme. In other cases, the provisional liquidators will displace the directors entirely for the duration of the restructuring. In either case, the provisional liquidators will be subject to the Court's supervision, and the Court's involvement in the scheme process will be the same irrespective of whether the company is in provisional liquidation.

3.5 How are creditors and/or shareholders able to influence each restructuring process? Are there any restrictions on the action that they can take (including the enforcement of security)? Can they be crammed down?

A scheme creditor or shareholder may be able to influence the scheme terms through holding sufficient votes to block the scheme at the meeting stage, and/or through membership of an *ad hoc* group or provisional liquidation committee. A dissentient creditor or shareholder also has the right to oppose the scheme at the sanction stage, although its options will generally be more limited at that point.

If a scheme takes place outside of a provisional liquidation process then there is no statutory bar preventing a creditor or shareholder from enforcing its rights prior to the scheme becoming effective, although

the Grand Court might be persuaded to exercise its discretion to stay or adjourn proceedings brought against the company by a scheme creditor or shareholder pending the completion of the scheme process. The appointment of provisional liquidators results in an automatic stay on actions against the company in Cayman, but this may not be effective to prevent actions being commenced or pursued against the company overseas.

In principle, secured creditors are capable of being bound by a scheme as it is the underlying debt rather than the security interest which is compromised by the scheme. In reality, secured creditors will be left out of a scheme or will have a significant influence on its terms, either because of their ability to enforce their security prior to the scheme becoming effective or because their security interest puts them into their own scheme class and therefore gives them a blocking position.

Dissentient creditors and shareholders who are included in a scheme are crammed down in accordance with the scheme terms upon the scheme becoming effective.

3.6 What impact does each restructuring procedure have on existing contracts? Are the parties obliged to perform outstanding obligations? Will termination and set-off provisions be upheld?

The impact of a scheme on existing contracts, and whether the parties will be obliged to perform outstanding obligations under those contracts or whether they will be terminated, will depend on the terms of the scheme (in particular the extent to which it purports to compromise rights under those contracts) and the terms of the contracts. If the scheme takes place in the context of a provisional liquidation then the appointment of provisional liquidators will not in and of itself affect existing contracts, other than as might be provided within the contracts themselves. Contractual rights of set-off would usually be relevant for the purpose of valuing a scheme claim.

3.7 How is each restructuring process funded? Is any protection given to rescue financing?

The process is funded from the scheme company's assets and/or from new money invested by way of debt or equity. In practice, new money comes from a wide variety of sources. Security can be granted in respect of rescue financing, but there is no statutory protection (or priority) afforded to rescue financing in the context of a scheme taking place outside of a provisional liquidation process. Similarly, rescue financing provided during a provisional liquidation will have no statutory protection (or priority) in the event that the company emerges from the provisional liquidation but subsequently fails. However, if rescue financing is provided during a provisional liquidation and the company is subsequently wound up without having emerged from the provisional liquidation process, i.e. because no restructuring was approved, then the financing is likely to constitute an expense of the provisional liquidation. As such it would have priority over the majority of official liquidation expenses and all unsecured creditors' claims in the official liquidation.

4 Insolvency Procedures

4.1 What is/are the key insolvency procedure(s) available to wind up a company?

Provisional liquidation

Provisional liquidation is available to companies liable to be wound up under the Companies Law, following the presentation of a winding up petition. A creditor, shareholder, the company itself or (in respect of regulated businesses) the Cayman Islands Monetary Authority ("**CIMA**") can apply for the appointment of provisional liquidators between the presentation and the hearing of the winding up petition.

Applications by creditors, shareholders or CIMA are made for the purpose of preserving and protecting the company's assets until the hearing of a winding up petition and the appointment of official liquidators.

A company can also petition for its own winding up and apply for the appointment of provisional liquidators in order to present a compromise or arrangement to creditors with the protection of an automatic stay. The purpose of appointing a provisional liquidator in this situation is similar to the UK administration process or US Chapter 11 procedure, albeit there are significant legal and procedural differences.

Official liquidation

The purpose of official liquidation is to wind up the company and distribute its assets to its creditors and shareholders in accordance with the statutory order of priorities.

Official liquidation is available to:

- companies incorporated and registered under the Companies Law;
- bodies incorporated under any other law; and
- foreign companies which:
  - carry on business or have property located in the Cayman Islands;
  - are the general partner of a limited partnership registered in the Cayman Islands; or
  - are registered as foreign companies under the Companies Law.

Winding up petitions may be presented by the company or (subject to the restrictions identified in question 2.2 above) by any creditor (including a contingent or prospective creditor) or shareholder of the company. CIMA may also present a petition in relation to a company which is carrying on a regulated business in the Cayman Islands.

Voluntary liquidation

Voluntary liquidation can be used by companies incorporated and registered under the Companies Law. It is commenced by shareholder resolution or on the expiry of a period or the occurrence of an event (*see below*). However, an application must be made to bring a voluntary liquidation under the supervision of the Court (at which point it proceeds as an official liquidation) if any of the directors is unable or unwilling to swear the requisite statutory declaration of solvency or in certain other circumstances.

4.2 On what grounds can a company be placed into each winding up procedure?

Provisional liquidation

A creditor or shareholder can apply on the grounds that there is a *prima facie* case for making a winding up order and the appointment of provisional liquidators is necessary to prevent:

- dissipation or misuse of the company's assets;
- oppression of minority shareholders; or
- mismanagement or misconduct by the directors.

As mentioned above, the company, if properly authorised, can apply for the appointment of provisional liquidators on the grounds that the company is or is likely to become unable to pay its debts and intends to present a compromise or arrangement to its creditors.

An application to appoint provisional liquidators can only be made following the presentation of a winding up petition.

Official liquidation

A company may be wound up by the Grand Court if any of the following apply:

- The company passes a special resolution requiring it to be wound up by the Court.
- The company does not commence business within a year of incorporation.
- The company suspends its business for a whole year.
- The period (if any) fixed by the company's articles for the company's duration expires, or an event occurs which under the articles triggers the company's winding up.
- The company is unable to pay its debts (*see below*).
- The Court decides that it is just and equitable for the company to be wound up.
- The company is carrying on a regulated business in the Cayman Islands and is not duly licensed or registered to do so.
- Certain other grounds specified in regulatory and other laws.

The test of inability to pay debts for this purpose is a cash-flow test. The company's balance sheet is irrelevant in this context. Based on earlier authorities, the cash-flow test in the Cayman Islands was generally regarded as being confined to debts which were presently due and payable. However, in *Conway and Walker (as joint official liquidators of Weavering Macro Fixed Income Fund Limited) v SEB* (18 November 2016, unreported), the Court of Appeal stated that "*the cash flow test in the Cayman Islands is not confined to consideration of debts that are immediately due and payable. It permits consideration also of debts that will become due in the reasonably near future*". Although the Court's comments were technically *obiter*, they are very likely to be followed by the Grand Court, such that a Cayman company may be liable to be wound up if it is presently unable to pay its debts, or if it will become so in the reasonably near future. What will constitute the "reasonably near future" for the purposes of the test will be fact specific in each case. The same cash-flow test is also used in relation to preference claims under section 145 of the Companies Law (see question 2.3 above).

If the debt claimed in the demand is disputed by the company in good faith and on substantial grounds then it cannot form the basis of a winding up petition.

Voluntary liquidation

A company can be wound up voluntarily in the following cases:

- When the fixed period, if any, for the duration of the company in its memorandum or articles expires.
- If an event occurs which the memorandum or articles provide is to trigger the company's winding up.
- If the company resolves by special resolution that it be wound up voluntarily.

If the company resolves by ordinary resolution that it be wound up voluntarily because it is unable to pay its debts as they fall due.

4.3 Who manages each winding up process? Is there any court involvement?

Provisional liquidation

Provisional liquidators are appointed by the Grand Court. They are subject to the Court's supervision and only carry out the functions which the Court confers on them. Their powers are prescribed by the order appointing them and the scope will depend on the reason for their appointment. If a company restructuring is proposed, existing management can be allowed to remain in control of the company subject to the supervision of the Court and provisional liquidators, although in other cases the management will be displaced entirely by the provisional liquidators. The Court may (or may not) direct that a provisional liquidation committee be established.

Official liquidation

Official liquidators are also appointed by the Grand Court and their authority always displaces that of the company's directors. The official liquidators control the company's affairs, subject to the Court's supervision. Certain of their powers are exercisable without the sanction of the Court, whereas others cannot be exercised without Court sanction. A liquidation committee is required to be established in every official liquidation.

Voluntary liquidation

On appointing a voluntary liquidator, the directors' powers cease, except to the extent the company (through a general meeting) or the liquidator sanctions the continuance of those powers. The Grand Court will not be involved in a voluntary winding up unless a petition is presented to bring it under the Court's supervision or the voluntary liquidator or any contributory applies to the Court to determine any question arising in the voluntary liquidation or with regard to the exercise of powers which the Court might exercise in a Court-supervised liquidation.

4.4 How are the creditors and/or shareholders able to influence each winding up process? Are there any restrictions on the action that they can take (including the enforcement of security)?

Provisional liquidation

Creditors or contributories of the company may apply to the Court for orders and directions with regard to the exercise or proposed exercise of the provisional liquidators' powers (these are known as "sanction applications").

A provisional liquidation committee comprising of creditors and/or shareholders may (but will not always) be established in a provisional liquidation. The composition and function of liquidation committees are addressed in more detail below in the context of official liquidations.

There is no restriction on the enforcement of security during a provisional liquidation, but the appointment of provisional liquidators triggers an automatic stay on the commencement or continuance of proceedings against the company without the leave of the Court.

Official liquidation

Creditors or contributories of the company may also make sanction applications with regard to the exercise or proposed exercise of the official liquidators' powers.

In addition, a liquidation committee must be appointed unless the Court orders otherwise. The principal purposes of a liquidation committee are to act as a "sounding board" for the liquidators and to consider the basis and amount of their remuneration. The committee comprises three to five creditors (if the liquidator has determined that the company is insolvent) or shareholders (if the liquidator has determined that the company is solvent). If the liquidator determines that the company is of doubtful solvency then the committee must comprise three to six members of whom a majority must be creditors and at least one of whom must be a shareholder. Members are elected at meetings of creditors and/or shareholders (as appropriate). Liquidation committees also have standing to make sanction applications.

There are no prohibitions or restrictions on the rights of secured creditors to enforce their security during an official liquidation but, as in provisional liquidations, no proceedings can be commenced or continued against the company without the leave of the Court.

Voluntary liquidation

Voluntary liquidators are required to pay debts owed to creditors as they fall due. If they fail to do so there is nothing to stop a secured creditor from enforcing its security or to prevent any creditor from commencing ordinary litigation or winding up proceedings against the company.

A contributory may apply to the Grand Court to determine any question arising in the voluntary winding up or with regard to the exercise of all or any of the powers which the Court might exercise if the company were being wound up under the Court's supervision.

4.5 What impact does each winding up procedure have on existing contracts? Are the parties obliged to perform outstanding obligations? Will termination and set-off provisions be upheld?

Other than contracts of employment (in respect of which see below), the winding up process *per se* will not have any effect on contracts unless there is a specific contractual provision to that effect. Further, liquidators have no statutory power to disclaim onerous contracts under Cayman law. The parties are therefore obliged to perform their outstanding obligations, although in practice a liquidator might elect not to do so and instead to adjudicate whatever claim the contractual counterparty seeks to prove in the liquidation as a result of the breach. Liquidators are required to give effect to any contractual rights of set-off or netting of claims between the company and any persons, subject to any agreement to waive or limit such rights. In the absence of any set-off provision, account must be taken of what is due from each party to the other in respect of their mutual dealings, and set-off is applied in relation to those amounts.

4.6 What is the ranking of claims in each procedure, including the costs of the procedure?

- Liquidation expenses, including liquidators' fees and disbursements.
- Preferential debts, which are:
  - certain sums due to employees;
  - certain taxes due to the Cayman Islands government; and
  - for certain Cayman Islands banks, certain sums due to depositors.
- Ordinary debts which are not otherwise secured, and not subject to subordination or deferral agreements, including debts incurred by the company in respect of the redemption or purchase of its own shares, provided the redemption or purchase took place before the liquidation commenced.
- Ordinary debts that are subject to subordination or deferral agreements.
- In an official liquidation lasting more than six months, interest accruing on the company's debts since commencement of the liquidation.
- Amounts due to preferred shareholders (under the company's articles of association).
- Debts due to the holders of redeemable shares in the company whose shares were due to be redeemed before the liquidation commenced but were not redeemed due to the company's default.

Any surplus remaining after payment of the above amounts is returned to the shareholders of the company in accordance with its articles or any shareholders' agreement.

4.7 Is it possible for the company to be revived in the future?

Liquidation is intended to be a terminal procedure and ordinarily results in the dissolution of the company. Once a company has been dissolved following a voluntary or official liquidation, it cannot be revived.

In certain circumstances, a voluntary liquidation can be recalled by the Court prior to dissolution and the company placed back into active status.

In an official liquidation the liquidator or any creditor or shareholder has the right to apply for the liquidation to be stayed prior to dissolution, and the Grand Court may make an order staying the proceedings, either permanently or for a limited time, on such terms and conditions as it thinks fit.

5 Tax

5.1 Does a restructuring or insolvency procedure give rise to tax liabilities?

Not in the Cayman Islands.

6 Employees

6.1 What is the effect of each restructuring or insolvency procedure on employees?

Employees' rights would only be affected by a scheme of arrangement if and to the extent that it purported to compromise their rights as creditors under their employment agreements. This would be unusual in practice. A voluntary or provisional liquidation would have no legal effect on employees save to the extent, if any, provided for in their employment agreement. Under the common law, a winding up order serves to terminate all contracts of employment of the company in official liquidation.

7 Cross-Border Issues

7.1 Can companies incorporated elsewhere restructure or enter into insolvency proceedings in your jurisdiction?

Yes. A foreign company can be the subject of a Cayman Islands scheme of arrangement or be wound up here provided that it has property located, or is carrying on business, in the Islands, is the general partner of an ordinary or exempted Cayman Islands limited partnership, or is registered as a foreign company under the Companies Law.

7.2 Is there scope for a restructuring or insolvency process commenced elsewhere to be recognised in your jurisdiction?

Yes. On application by a foreign representative (defined as a trustee, liquidator or other official appointed for the purposes of a foreign

bankruptcy proceeding), the Grand Court can make orders ancillary to the foreign bankruptcy proceedings to:

- Recognise the foreign representative's right to act in the Cayman Islands on behalf, or in the name, of the debtor.
- Grant a stay of proceedings or the enforcement of a judgment against the debtor.
- Require certain persons with information concerning the debtor's business or affairs to be examined by, and produce documents to, the foreign representative.
- Order the turnover of the debtor's property to the foreign representative.

7.3 Do companies incorporated in your jurisdiction restructure or enter into insolvency proceedings in other jurisdictions? Is this common practice?

Yes, Cayman companies with extra-territorial assets will regularly enter into concurrent insolvency regimes in other jurisdictions; for example, under Chapter 11 or Chapter 15 of the US Bankruptcy Code. In such circumstances, Cayman liquidators must consider whether or not it is appropriate to enter into an international protocol with any foreign officeholder in order to promote the orderly administration of the estate and avoid duplication of work and conflict.

8 Groups

8.1 How are groups of companies treated on the insolvency of one or more members? Is there scope for co-operation between officeholders?

It depends on where the insolvent company sits within the group. Liquidators of the holding company will, generally speaking (and subject to applicable local laws), have the ability to take control of and/or sell the company's subsidiaries. If multiple Cayman companies within the group enter into insolvency proceedings then the Grand Court will, where appropriate, appoint the same or common liquidators. Although there are no formal provisions for cooperation between liquidators of different companies within a group, this may occur informally in practice to the extent it is in the interests of both estates. In certain limited circumstances the Grand Court may be willing to make an order by which the assets and liabilities of different companies within a group are pooled.

9 Reform

9.1 Are there any proposals for reform of the corporate rescue and insolvency regime in your jurisdiction?

There are no formal proposals for reform of the insolvency regime in place at this point in time.

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Campbells

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