The zone of insolvency: what directors and companies need to know

Mark Goodman
Partner, Campbells
mgoodman@campbellslegal.com

Guy Manning
Partner, Head of Litigation, Insolvency & Restructuring, Campbells
gmanning@campbellslegal.com

Katie Logan
Associate, Campbells
klogan@campbellslegal.com

With global vaccination rates lifting consumer sentiment there are reasons to be optimistic about economic recovery from the global pandemic. However, new virus mutations, uneven vaccination rates, and reducing levels of government economic support measures all mean that the economic outlook remains uncertain and many market sectors will continue to face challenges in the medium term.

It is therefore very important for company directors, and those who advise them, to properly understand and manage their obligations when a company is (or is approaching) a point where it may be unable to pay debts as and when they fall due.

While this article is focused on the law of the Cayman Islands, similar principles will apply in other common law jurisdictions and virtually all well-developed legal jurisdictions have some mechanism by which a company can reorganise indebtedness so as to avoid the catastrophic failure of its business. The principles are therefore of general application, but are not a substitute for taking specific advice.

Duties of Cayman Islands directors

Directors' duties are not codified by statute and remain governed by a combination of common law principles, certain duties found in statute[1] and any additional duties prescribed in the company's articles of association.

A director's duties include the fiduciary duties to act in good faith in promoting the best interests of the company, to act for a proper purpose, to exercise independent judgement, and to avoid conflicts of interest.

Cayman Islands directors also have a duty to carry out their role with the care and skill that might reasonably be expected of someone carrying out the directorship at the time.

The above duties are owed to the company itself, rather than directly to its shareholders or creditors (as is the case in some jurisdictions). When a company is solvent, the interests of the company are equated with the interests of shareholders. However, the interests of the company are viewed differently when the company is in financial difficulty.

What is meant by the best interests of the company in times of financial difficulty was considered by the Grand Court of the Cayman Islands (Grand Court) in *Prospect Properties v McNeill* [1990-91]. In that case, the Grand Court[2] 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.

Zone of insolvency

A company which has a healthy balance sheet and reliable future receivables, but due to a short-term liquidity crunch is unable to satisfy immediately due and payable liabilities is technically cash-flow insolvent, but not insolvent in any real commercial sense. Similarly, a company which has overstated the value of its assets on its balance sheet and which has no future receivables, but which has sufficient cash to satisfy immediately due and payable

> **In considering balance sheet insolvency, regard should be had to contingent and prospective assets and liabilities, with a healthy dose of realism applied to elements of uncertainty.**

liabilities is technically cash-flow solvent, but is not solvent in any real commercial sense.

For this reason, insolvency in this context should not be analysed by a slavish observance of the cash-flow test (ie the inability to pay liabilities as and when they fall due[3]) or the balance sheet test (ie when the value of the liabilities on the balance sheet exceeds the value of assets), but by taking a more commercially pragmatic view as to when the company may be commercially insolvent, or where commercial insolvency is a real risk – the so-called 'zone of insolvency'.

To facilitate a commercial assessment of solvency, the directors of a company should consider cash-flow insolvency in the context not only of those liabilities which are immediately due and payable, but also those which are due and payable in the reasonably near future (*Re Cheyne Finance Plc* [2008]). In considering balance sheet insolvency, regard should be had to contingent and prospective assets and liabilities (*BNY Corporate Trustee Services Ltd v Eurosail-UK* [2013]), with a healthy dose of realism applied to elements of uncertainty, for example the relative value of currencies over time or the collectability of ageing receivables. This allows directors (and those that advise them) to more appropriately consider whose interests are at stake, whether shareholders, creditors or both, and to act accordingly in making decisions with respect to the management of the company.

Consequences for directors

Although there is no point prescribed by statute at which a company must enter into a restructuring or insolvency process, and no requirement to show that the company is effectively beyond 'the point of no return'[4], directors can be made personally liable to the company for any losses which they cause to the company if they act in breach of their duty to act with regard to the interests of creditors.

Examples of such a loss may include any additional liabilities incurred when the director knew, or should have known, that there was no reasonable prospect of the company being able to pay those liabilities or avoiding insolvent liquidation. Certain statutory provisions prevent dispositions of assets which seek to prefer one creditor over others, dispositions of assets at an undervalue, or the carrying on of business with the intent to defraud creditors.

It is in the interests of the creditors to be paid, and equally, it is in the interests of the company to be safeguarded against being put in a position where it is unable to pay its creditors. When a company is nearing or is in the zone of insolvency, a director will therefore need to focus on strategies that ensure the highest possible return to creditors.

Potential for restructuring

Once the company is at or near the zone of insolvency, the best interests of the company (including creditors) would usually require proper consideration of restructuring options.

Commonly, a restructuring will involve some or all of the following components:

- significant operational or structural changes with a view to achieving greater efficiency;
- a deferral of liabilities through refinancing or renegotiation of terms with creditors;
- a reduction of debt through a compromise of creditor claims or a 'debt for equity' swap; and/or
- the injection of fresh working capital.

In the Cayman Islands (and various other common law jurisdictions) a restructuring may be effected by way of a scheme of arrangement. The scheme of arrangement is a form of statutory contract which is binding on all those who are subject to the scheme if it is approved by:

1) a majority in number, representing 75% by value, of those attending and voting at a meeting convened for the purpose of considering the scheme; and

2) the Grand Court. In considering whether to approve (sanction) a scheme the court

> **The key advantages of a restructuring are that it preserves jobs, preserves value, avoids the need for a fire sale of assets.**

will consider, among other factors, the fairness of the scheme.

The scheme of arrangement therefore represents a flexible mechanism for effecting a compromise or arrangement with creditors which does not require full approval from creditors to be effective.

If necessary in the circumstances, the company can protect itself from adverse creditor action by seeking the appointment of provisional liquidators. Where the directors have the power in the company's articles of association (or, if not, where they are specifically authorised to do so by the shareholders in general meeting[5]), the directors can bring about a provisional liquidation by causing the company to present a petition for the winding up of the company and thereafter seeking the appointment of provisional liquidators to facilitate the presentation of a compromise or arrangement to creditors. Where the directors are not authorised, either by the articles or the shareholders, to present a winding up petition in the name of the company, common practice[6] is to encourage the presentation of a winding up petition by a 'friendly' creditor to open the jurisdictional gateway for the company to apply for the appointment of provisional liquidators.

The effect of the appointment of provisional liquidators is to bring about a moratorium on claims against the company, including any criminal proceedings, without the leave of the Grand Court. The moratorium prevents adverse creditor action and provides the company with breathing space so it can formulate and propose a restructuring arrangement. A number of recent cases have confirmed that the Grand Court will give priority to credible restructuring proposals, preferring to see companies avoiding an insolvent winding up process where possible.

The key advantages of a restructuring are that it preserves jobs, preserves value, avoids the need for a fire sale of assets and potentially reduces professional fees. Accordingly, directors of a company at or near the zone of insolvency (and those who advise them) should consider restructuring options sooner rather than later and should seek specialist professional advice at the earliest opportunity to protect both themselves and the interests of shareholders and creditors. ■

BNY Corporate Trustee Services Ltd v Eurosail-UK
[2013] UKSC 28
CHC Group Ltd
Unreported, McMillan J, Cause No FSD 5 of 2017
Prospect Properties v McNeill
[1990-91] CILR 171
Re Cheyne Finance Plc
[2008] EWHC 2402 (Ch), [2008] BCC 182
Re China Shanshui Cement Group Ltd
[2015] (2) CILR 255
Re Oryx Natural Resources
[2007] CILR N [6] (Grand Court)

Campbells

Notes

1) Primarily the Companies Act (2021 Revision).

2) Following a well-established line of English authorities.

3) Being the test for insolvency usually applied by the Grand Court (see Grand Court Rules 2021, rules 92 and 93; *Re Oryx Natural Resources* [2007] CILR N [6] (Grand Court)).

4) The formulation of the balance sheet test applied by the Court of Appeal, but rejected by the Supreme Court, in *BNY Corporate Trustee Services Ltd v Eurosail-UK* [2013].

5) See *Re China Shanshui Cement Group Ltd* [2015], where Mangatal J held that directors had no authority to cause the company to present a petition in its own right unless expressly authorised by either the articles of association or the shareholders in a general meeting.

6) See, for example, *CHC Group Ltd* [2017].