Campbells

Cayman Insolvency & Restructuring: A Review of 2021

Liam Faulkner, a Partner in our Cayman Islands' Insolvency & Restructuring team, provides an overview of the past year including the insolvency statistics, the restructuring case of the year, a summary of the key judgments and the legislative amendments to be enacted in 2022.

Table of Contents

The stats

According to the court maintained public register, 51 winding up petitions were presented in 2021 comprised of 22 creditors' petitions (43%), 9 petitions presented by shareholders or limited partners seeking a winding up order on just and equitable grounds (18%), 6 petitions presented by companies for the primary purpose of appointing provisional liquidators to facilitate a debt restructuring (12%) and 14 petitions presented by companies in voluntary liquidation seeking an order to bring the liquidation under the supervision of the court on the ground of insolvency (27%).

- Creditor petitions: Of the 22 creditor petitions presented in 2021, 15 were determined during the 2021 calendar year (68%). Of the seven outstanding petitions, four were presented in Q4 2021 (and due to be heard in early 2022) with the remaining three the subject of ongoing restructuring efforts or negotiations. 15 of the 22 creditor petitions concerned companies or funds with their primary operations in Asia (68%), predominantly in the PRC, with the remainder subject companies operating in the US or the Middle East. The subject companies covered a range of operational sectors including investment fund vehicles (40%), the oil and gas sector (14%) and private education providers in the PRC (9%).

  Of the 15 creditor petitions presented and determined in 2021, 9 winding up orders were made (60%), 3 petitions were dismissed as an abuse of process (20%), 2 petitions were withdrawn before the hearing (presumably but not necessarily following negotiations between the debtor and creditor) (13%) and 1 petition was heard but adjourned to facilitate a potential restructuring (7%). Of the 9 winding up orders made on a creditor's petition, 8 of the orders were made within 4-8 weeks of the petition being presented (89%) with the remaining winding up order being made 12 weeks after the petition was presented. The average period between the presentation and hearing of a creditor's winding up petition was 6 weeks.

  An additional 5 winding up orders were made in 2021 as a result of a creditor's petition having been presented prior to 1 January 2021: 2 of those petitions were filed in Q4 2020 with orders being made in Q1 2021 and 3 were filed between 2017 and 2019 but were adjourned to allow for restructuring options to be explored (which were ultimately unsuccessful).

- Supervision petitions: Each of the 14 petitions filed by companies in voluntary liquidation for an order to bring the liquidation under the supervision of the court cited the absence of a declaration of solvency from a director of the company within the prescribed period of 28 days of the commencement of voluntary liquidation. In practice, an insolvent company seeking a winding up order will typically place the company into voluntary liquidation on the understanding that no declaration of solvency will be forthcoming and the voluntary liquidators will proceed to seek a supervision order which can result in a more time and cost effective process compared to the company presenting a petition on the ground of its own insolvency. Absent any objections from creditors, the court tends to deal with the application administratively without the need for a hearing within 4 weeks of the petition being filed.

- Member petitions: 9 winding up petitions were presented by shareholders or limited partners seeking a winding up order on the just and equitable ground. Each of the 9 petitions alleged (amongst other grounds) a loss of trust and confidence in management arising from complaints as to conduct. Just and equitable petitions are typically disputed and can take 9-12 months (and potentially longer) to be determined. Of the 9 petitions presented in 2021, only two winding up orders were made (22%) with two petitions being voluntarily withdrawn by the petitioner before being determined (22%). 5 of the 9 petitions were the subject of strike out applications: 2 strike out applications were successful, 1 was dismissed and 2 remain pending.

- Schemes of arrangement: An additional 16 petitions were filed in 2021 seeking the court's approval of a scheme of arrangement. Of those schemes, 9 related to take private transactions of Cayman companies listed on the Hong Kong Stock Exchange with their primary operations in the PRC (56%), 1 scheme was in furtherance of a going public transaction of a company operating in the African mining sector (6%) and 6 schemes related to debt restructurings of companies with their primary operations in the PRC (38%).

Restructuring case of the year: Luckin Coffee Inc.

The highest profile restructuring matter in the Cayman Islands in 2021 was the Luckin Coffee Inc. scheme of arrangement relating to the restructuring of its US$460 million 0.75% Convertible Senior Notes due 2025. The scheme became effective on 17 December 2021 following sanction of the scheme by the Cayman court and an order from the US Bankruptcy Court for the Southern District of New York giving full force and effect to the scheme in the US, which was necessary given that the notes were governed by New York law. The restructuring contemplated in the scheme is expected to become effective in late January 2022. Under the restructuring, the liabilities under the notes will be discharged in return for consideration comprised of cash, new debt securities and equity securities.

The scheme, which received the unanimous support of creditors present and voting at the scheme meeting, marks a successful outcome for the company, its provisional liquidators and its creditors following a turbulent period for the company. Founded in 2017, Luckin Coffee operated a prominent retail coffee business in the PRC with over 4,000 stores in 56 cities making it one of the largest coffee networks in the PRC. Following an IPO on the Nasdaq in May 2019, the company's share price rose from US$17 to US$51 by January 2020 before the impact of Covid-19 forced the company to temporarily close many of its stores in the PRC. An announcement in April 2020 that the company had suspended its COO after an investigation found that he had fabricated 2019 sales by approximately US$310 million resulted in the company's share price collapsing by over 70% in value, wiping out over US$5 billion from its market value, prior to the shares being suspended from trading before ultimately being delisted.

Following a winding up petition being presented by a "friendly" creditor on 10 July 2020, restructuring provisional liquidators, Alexander Lawson of Alvarez & Marsal Cayman Islands Limited and Wing Sze Tiffany Wong of Alvarez & Marsal Asia Limited, were appointed by the Cayman court on 15 July 2020, with the provisional liquidation of the company being recognised as a foreign main proceeding by the US Bankruptcy Court on 30 March 2021, effectively staying all proceedings against the company and its assets in the US. Following extensive negotiations over a period of six months, a restructuring support agreement was entered into in March 2021 with an ad hoc group of noteholders representing over 59% in aggregate of the principal amount of the outstanding notes with over 75% of the noteholders entering into the RSA by October 2021.

Legislative amendment: the introduction of a new restructuring regime

Where a distressed company is unable to reach a consensual agreement with its creditors, it will typically need to promote a scheme of arrangement as a debt restructuring mechanism which is binding on all creditors of the same class and has the ability to cram down a dissenting or non-responsive minority. The objective of any scheme is to ensure that the financially distressed company continues as a going concern whilst providing a better return for the company's creditors than would otherwise be the case if the company were to enter into liquidation (which is typically the realistic alternative).

In December 2021, the long awaited Companies (Amendment) Act, 2021 was gazetted which seeks to address three principal areas for improvement in the current restructuring regime:

- Restructuring officers instead of provisional liquidators: Under the current regime, where a company considers that a moratorium on claims is essential to the success of the restructuring it will need to present a winding up petition and obtain an order appointing provisional liquidators with a restructuring mandate in order to invoke the moratorium. However, there has sometimes been a reluctance on the part of companies in the past to take these steps due to the negative connotations associated with the appointment of "liquidators" (albeit provisional) and the impact that can have on how the company is perceived by its current and future stakeholders. To address this issue, the proposed amendments will allow a Cayman company to restructure under the supervision of a "restructuring officer" and provide for an automatic stay on creditor action in the restructuring period. The proposed amendments should operate in a way similar (although not identical) to the administration procedure in England or Chapter 11 proceedings in the United States.

- Empowering the Board to act without a member's resolution: Under the current regime, the presentation by a company of a winding up petition is necessary in order to apply for the appointment of provisional liquidators to invoke a moratorium on claims. Presenting the petition requires the authorisation of a resolution of the company's members (unless the company was incorporated after 1 March 2009 and its articles expressly authorise the directors to do so). This occasionally gives rise to a tension between the Board, who wish to implement a scheme having regard to the best interests of creditors, and the shareholders who owe no duties to creditors and are entitled to exercise their voting rights having regard to their own perceived best interests. The proposed amendments to the Companies Act address this issue for companies incorporated after the enactment of the amendments by providing that a restructuring petition may be presented *by a company acting by its directors, without a resolution of its members or an express power in its articles of association* for the appointment of a "restructuring officer" on the ground 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, unless the company's articles expressly provide otherwise.

- Abolishing the headcount test for shareholder schemes: Under the current regime, both creditor and member schemes require the approval of a simple majority in number representing 75% in nominal value of those present and voting at the scheme meeting, either in person or by proxy. The requirement for a majority in number has resulted in practical difficulties where the consent of a majority in number of a listed company's registered members is required due to the common use of central depositories which only count as one member under the headcount test with one vote, giving rise to a numerosity issue. Under the proposed amendments the headcount test for creditor schemes will remain but be abolished for member schemes which going forward will only require the approval of 75% in nominal value of those members present and voting at the scheme meeting.

Whilst gazetted the Companies (Amendment) Act, 2021 is not yet in force but is expected to be enacted shortly.

Developments in parallel Cayman and Hong Kong Schemes of Arrangement

Approximately 58% of all companies listed on the Hong Kong Stock Exchange (1,509 out of a total of 2,602 companies) are incorporated in the Cayman Islands, with a majority of those companies having their primary operations in the PRC.

In recent years the accepted best practice for Cayman incorporated Hong Kong listed companies looking to restructure their debt has been to pursue parallel schemes of arrangement in both the Cayman Islands and Hong Kong, whilst seeking the appointment of restructuring provisional liquidators in the Cayman Islands as the place of incorporation in order to protect against disruptive creditor actions whilst the restructuring is ongoing. The appointment of provisional liquidators in the Cayman Islands is necessary in order for any liquidator appointed to have the benefit of the wide powers granted by the Companies Act and to invoke a moratorium on claims being commenced against the company in the Cayman Islands (which are not available to a liquidator appointed by a foreign court over a Cayman incorporated company).

Occasionally, in certain situations, the Hong Kong court will accept jurisdiction to make a winding up order or appoint provisional liquidators in respect of a Cayman incorporated company, including but not limited to where the company has a sufficient connection to Hong Kong and there are creditors within the jurisdiction. In the matter of *Freeman Fintech Corporation Limited*, the Cayman court adopted a cooperative rather than territorial approach by exercising its jurisdiction under the common law to grant recognition and assistance to joint provisional liquidators appointed by the Hong Kong court over a Cayman company listed in Hong Kong for the purpose of the company presenting parallel schemes of arrangement to its creditors to restructure HK$2 billion of debt mostly governed by Hong Kong law, including authorising the Hong Kong JPLs to present a petition on behalf of the company for the scheme in the Cayman Islands. In granting the assistance sought, the Cayman court concluded that separate winding up proceedings in the Cayman Islands would, on the facts of the case, serve no purpose other than to incur costs and delay matters and therefore exercised its discretion to grant the relief sought. The parallel schemes of arrangement were subsequently sanctioned by both courts in February 2021 resulting in an effective restructuring of the company's debt.

A series of decisions from the Hong Kong Court during 2021 has sought to question the necessity of a parallel scheme in the place of incorporation (e.g. Cayman) where the debt can be effectively compromised by a Hong Kong scheme, such as where the debt is governed by Hong Kong law and all or most of the company's creditors are situated in Hong Kong. The Hong Kong Court has indicated that going forward the onus will be on the company to justify why parallel schemes, and the associated costs, are necessary by reference to the interests of unsecured creditors.

In December 2021, Justice Doyle of the Grand Court considered the recent judgments of the Hong Kong court when considering an application to appoint restructuring provisional liquidators to promote a Cayman Islands scheme of arrangement in respect of the debts of Silver Base Group Holdings Limited, a Cayman incorporated Hong Kong listed company which was the subject of an existing creditor's winding up petition in Hong Kong. In granting the application to appoint Cayman provisional liquidators to monitor the Board, conduct investigations into the company's affairs and consult with creditors in respect of the feasibility of a restructuring plan, Doyle J emphasised the importance of the laws of a company's place of incorporation on all matters concerning the company's existence and the international recognition of light-touch provisional liquidators appointed by the Cayman court for restructuring purposes. Whilst Doyle J noted that the appointment would not stop the winding up proceedings commenced in Hong Kong if the Hong Kong court decides not to recognise the Cayman statutory moratorium in respect of any proceedings in Hong Kong, Doyle J expressed his view that it would be "sensible and appropriate" for the Hong Kong court to recognise and grant assistance to the Cayman Islands provisional liquidators to promote a restructuring for the benefit of the company's creditors.

Doyle J raised the prospect of a protocol being entered into between the Cayman and Hong Kong courts in the future to provide for court to court communications when dealing with similar cases involving companies with connections to both jurisdictions. Whilst not referred to by Doyle J in his judgment, the foundation for such a protocol could be found in the Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters, also known as the JIN Guidelines, which were established in 2016 to promote communication and cooperation amongst courts, insolvency representatives and other parties involved in cross-border insolvency proceedings, including the conduct of joint hearings, and adopted by sixteen jurisdictions including the Cayman Islands and Hong Kong.

Exempted Limited Partnerships

Exempted limited partnerships (ELPs) are the investment vehicle of choice for private equity and mutual funds incorporated in the Cayman Islands. In October 2021, Justice Parker held in the matter of *Padma Fund LP* that the court does not have jurisdiction to grant a winding up order against an ELP on a creditor's petition and in doing so held that previous decisions of the court to the contrary had been wrongly decided. In his judgment Parker J reiterated that an ELP is a modified form of a general partnership which does not have legal personality. In circumstances where the ELP acts by its general partner, who holds the assets of the partnership on a statutory trust for the partners and where the general partner has unlimited liability for the liabilities of the ELP in the event that the partnership assets are insufficient to discharge them, the correct procedure consistent with the relevant provisions of the Exempted Limited Partnership Act is for a creditor to enforce its debt against the general partner directly. The impact of the decision in *Padma Fund LP* on a winding up petition presented by a limited partner against an ELP on the just and equitable ground is set to be considered in two separate matters before Doyle J in January 2022.

Segregated Portfolio Companies

Segregated portfolio companies are widely used for Cayman incorporated captive insurance, structured finance and multi-class investment funds due to the ability to segregate assets and liabilities into separate portfolios, in respect of which cross-investment or transfer of assets between portfolios is not permitted. Each portfolio is deemed to have its own assets and liabilities and the assets of one portfolio cannot be used to discharge the liabilities of another, notwithstanding that the portfolio does not have a legal personality separate from the company.

As each segregated portfolio does not have a separate legal personality, it is not possible for a creditor or member to petition to wind up the portfolio; a winding up order can only be made against the company as a whole (being a legal entity capable of being wound up and dissolved). It is however possible for an aggrieved member or creditor to apply to the court to appoint a receiver over a segregated portfolio under section 224 of the Companies Act where (i) the segregated portfolio assets attributable to the portfolio are or are likely to be insufficient to discharge the claims of creditors in respect of that segregated portfolio and (ii) the making of an order would achieve the orderly closing down of the business of or attributable to the portfolio and the distribution of portfolio assets attributable to the Portfolio to those entitled to have recourse to them.

In an August 2021 decision, Justice Parker held in the matter of *Obelisk Global Gold Focus Fund* that when determining a section 224 application to appoint a receiver over a segregated portfolio, the court is required to apply a balance sheet insolvency test to the portfolio, which differs to the commercial cash flow insolvency test to be applied when seeking to wind up a company.

The conflict test applicable to nominee liquidators

In the August 2021 decision in *Global Fidelity Bank (in voluntary liquidation)*, Doyle J confirmed the three stage approach for assessing the independence of nominee liquidators which was initially laid down by Jones J in *Hadar* and subsequently applied by Chief Justice Smellie in *Bay Capital* and *Alpha Re*. When determining whether a particular personal, professional or economic relationship may lead to a conclusion that an insolvency practitioner cannot be properly regarded as independent the case law stresses that the court must (i) identify the relationship, (ii) determine whether it is capable of impairing the appearance of independence and, if so, determine (iii) whether it is sufficiently material to the liquidation in question that a fair-minded stakeholder would reasonably object to the appointment of the nominated practitioner in question.

The court takes into account the subjective views of all stakeholders including, where relevant, creditors and contributories. The court also undertakes a full and careful assessment of all the circumstances of the case and all the objective factors that are relevant to determining who should be appointed JOLs. The court may, despite the subjective views of significant creditors, conclude that on an objective analysis no reasonable perception of lack of independence has been established. On an issue such as the identity of the JOLs subjective views of one, albeit significant, creditor cannot dictate the correct legal result for the court. The court takes into account the subjective views of the creditors but the court must consider the law and the facts and circumstances of each case and reach the appropriate determination as to the identity of the JOLs itself.

Role and function of the liquidation committee

In an April 2021 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 function 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.

Court confirms the four hurdles test to appoint provisional liquidators with an asset preservation mandate

In the August 2021 decision in *ICG I*, Justice Doyle, in dismissing an application to appoint a provisional liquidator with an asset preservation mandate over a company which was the subject of a winding up petition, confirmed that on a plain reading of section 104(2) of the Companies Act an applicant has four main hurdles to overcome:

- presentation of the winding up petition: the applicant must satisfy the court that a winding up petition has been duly presented and a winding up order has not yet been made;
- standing: the applicant must satisfy the court that the applicant has standing to make the application to appoint a provisional liquidator, i.e. the applicant is a creditor or contributory of the company;
- prima facie case: the applicant must satisfy the court that there is a *prima facie* case for making a winding up order on the petition; and
- necessity: the applicant must satisfy the court that the appointment of the provisional liquidator is necessary in order to prevent the dissipation or misuse of the company's assets; and/or the oppression of minority shareholders; and/or mismanagement or misconduct on the part of the company's directors.

The two hurdles which will often be the hardest to clear are the *prima facie* case hurdle and the necessity hurdle. On the *prima facie* case hurdle, it is not necessary for the applicant to demonstrate that a winding up order will be granted; a *prima facie* case is established where it is likely, on the basis of a case established by allegations supported by evidence which have not been disproved at the interim stage, that the petitioner would obtain a winding up order on the hearing of the petition. In respect of the necessity hurdle, there must be clear or strong evidence to show that there is a serious risk that one or more of the wrongs identified in section 104(2)(b) of the Companies Act may well occur if provisional liquidators are not appointed.

Litigation Funding

The Private Funding of Legal Services Act, 2020 came into force on 1 May 2021 abolishing the outdated torts of maintenance and champerty in the Cayman Islands and paving the way for a new age of litigation funding and contingency fee arrangements in the jurisdiction. The stated objective of the Act is to regulate contingency fee arrangements and litigation funding agreements in order to provide an alternate means of funding legal services. The Act has already been put to use by a number of court appointed liquidators in order to fund high value claims against third party wrongdoers for the benefit of creditors as a whole.

Campbells in 2021

2021 was another busy year for Campbells' market leading insolvency and restructuring team. We had a leading role in most of the significant cases in 2021 including the following matters:

- we acted for the Cayman restructuring joint provisional liquidators in *Luckin Coffee Inc*, Alexander Lawson of Alvarez & Marsal Cayman Islands Limited and Wing Sze Tiffany Wong of Alvarez & Marsal Asia Limited;
- we acted for the Hong Kong appointed restructuring joint provisional liquidators in *Freeman Fintech Corporation Limited*;
- we acted for the joint official liquidators of ABRAAJ Investment Management Limited, Stuart Sybersma and Paul Leggett of Deloitte & Touche LLP following the collapse of what was once the world's largest emerging markets private equity group with US$14 billion AUM;
- we acted for *Padma Fund LP* in successfully opposing a creditor's petition presented against an ELP on jurisdiction grounds;
- we appeared in two separate trials of a contributory's just and equitable winding up petition, one for the petitioner and one for the respondent, and are currently acting in other just and equitable winding up proceedings which are expected to proceed to trial in 2022;
- we acted for the applicant creditor in seeking the appointment of a receiver over a segregated portfolio of *Obelisk Global Gold Focus Fund*;
- we acted for the largest creditor in the *Global Fidelity Bank* liquidation;
- we successfully opposed the application brought by a purported contributory of ICG I to appoint provisional liquidators over the company and were subsequently successful in obtaining an injunction and the appointment of receivers over ICG I on behalf of our client.

Outlook for 2022

The eyes of the Cayman Islands insolvency and restructuring community (and beyond) at the outset of 2022 are fixed on the PRC debt bubble and, in particular, the highly distressed property sector with reports indicating that US$19.8 billion of offshore debt is due for payment from PRC property developers in Q1 2022 alone. A significant amount of the debt is understood to be structured through Cayman incorporated holding companies with the effect that the Cayman Islands is the most appropriate jurisdiction for any restructuring to take place.

Liam Faulkner
Partner
D +1 345 914 5866
C +1 345 325 5866
lfaulkner@campbellslegal.com

Guy Manning
Partner,
Head of Litigation & Insolvency
D +1 345 914 5868
C +1 345 525 5868
gmanning@campbellslegal.com

Mark Goodman
Partner
D +1 345 914 5898
C +1 345 525 5898
mgoodman@campbellslegal.com

Shaun Folpp
Managing Partner
D +852 3708 3010
C +852 9280 0761
sfolpp@campbellslegal.com