BVI AND CAYMAN INSOLVENCY LAW – A COMPARISON

Colin Riegels, **Ian Mann** and **Marc Kish** of **Harney, Westwood and Riegels** explore the similarities and differences between British Virgin Islands (BVI) and Cayman Islands insolvency laws and how to manage the disputes consequences of differences between each jurisdiction

To the uninitiated, offshore legal systems sometimes look like teen-pop boy bands; although you are pretty sure that there are some differences between them, they can all look rather generic unless you look at them very closely. In the case of offshore jurisdictions, noting their general resemblances is often more helpful than focusing in on granular differences between them – until offshore companies enter financial distress, when those differences can become much more starkly magnified. Such differences matter in litigation, and can affect the progress of later court applications.

In the case of the BVI and Cayman Islands, the two most popular offshore jurisdictions, there are certain differences of terminology between the two jurisdictions which can be glossed over. For example, in the Cayman Islands (Cayman) the applicable rules talk of 'winding up' and 'lodging a proof', whereas in BVI the equivalent terms are 'going into liquidation' and 'making a claim'. We have used equivalent terms interchangeably on the basis that they will be generally familiar to most legal practitioners.

Overview

The BVI's insolvency regime is codified in the Insolvency Act 2003 and the Insolvency Rules 2005, which are respectively the longest statute and the longest statutory instrument in the BVI. Cayman's relevant laws are predominantly found in the Companies Law (2013 Revision) and the Companies Winding Up Rules 2008. In both systems the common law continues to regulate a number of matters, although probably more so in Cayman than in the BVI.

Overall it is fair to say that both insolvency regimes are more similar than different; they are largely faithful to their common law pedigree and maintain *pari passu* treatment of claims, subject to respecting the rights of secured creditors, preferential creditors and rights of set-off. Both jurisdictions largely eschew debtor-in-possession forms of rehabilitation, and jealously guard the rights of secured creditors to enforce their security before and after the commencement of liquidation.

Winding up

The provisions for winding up a company in the BVI and Cayman are broadly similar, but with one key exception: under BVI law, a former member whose claim against the company arose pursuant to an obligation of the company in its Articles of Association (i.e. for unpaid dividends or redemption proceeds) has no standing to apply for the appointment of a liquidator. This is different in Cayman; they may have standing as a creditor once the date for payment has passed, or otherwise on just and equitable grounds. Conversely, in Cayman a member with no economic interest in the outcome may not petition for winding up a company on the basis of insolvency, but in the BVI they may do so.

Both jurisdictions permit a company to be wound up either on the basis of insolvency, or because it is just and equitable to do so, or (upon the application of the regulator) in the public interest.

Insolvency test

Although the statutes use different terminology, the litigation tests for insolvency in both the BVI and Cayman are very similar. In the BVI the relevant provisions are crystallised into a single statutory provision; a company will be deemed insolvent if it is either cash-flow insolvent or balance-sheet insolvent, or it fails to satisfy a statutory demand or a judgment debt.

In Cayman the test before the court is expressed simply in terms of being "unable to pay its debts" i.e. a cash-flow test, which

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includes being deemed to be unable to pay its debts by failing to pay a judgment debt or valid statutory demand.

However, case law has also made it clear that demonstrating a company's balance-sheet insolvency may also be sufficient to satisfy the court that it is unable to pay its debts, and will be a relevant factor on a just and equitable winding up petition. Either form of evidence may be presented to the court to satisfy the test, according to the facts at hand.

In Cayman, unless the court otherwise directs, a liquidation committee must be established in respect of every company which is being wound up by the court. The composition of that committee will be determined according to the solvency of the company, and will play a key role in the conduct of the winding up of the Cayman company. By contrast, the use of liquidation committees is virtually unheard of in the BVI, and no statutory provision is made for one, removing an extra layer from proceedings.

Treatment of claims

The commencement of winding up does not prevent a secured creditor enforcing their security rights in either jurisdiction. Also, there is a small class of preferred creditors (largely employees' benefits and government claims) which rank ahead of ordinary creditors and floating charge holders. However, only in Cayman does the class of preferred creditors include bank depositors.

In each jurisdiction the priority of unsecured claims in a winding up is broadly the same. The expenses of the liquidation are paid first, followed by the preferred creditors, then the floating charge holders, all of the ordinary claims, then post-insolvency interest. Any remaining assets are then distributed among creditors whose claims are based upon their rights as shareholders, and then finally any surplus is distributed among the shareholders in accordance with their rights under the memorandum and articles.

Netting and set-off

For both jurisdictions there is provision for set-off of mutual claims upon a company going into insolvency, and this benefit can be waived (although in the BVI it can only be waived where this would not adversely affect another creditor). The right to set-off may be lost, but the applicable test differs. In Cayman the right to set-off is lost if the creditor knew that the company was the subject of a winding up petition at the time of extending credit, whereas in the BVI the set-off right will be lost if the creditor knew that the company was insolvent at that time (irrespective of whether a petition for the appointment of a liquidator had been presented).

Similarly, in both jurisdictions there is statutory validation of subordination agreements, and netting arrangements. However, where Cayman permits multi-lateral netting to prevail over the statutory set-off rules, in insolvency scenarios BVI law limits the protection of netting arrangements to two-party netting.

Avoidance of transactions

Transactions entered into after the commencement of winding up are void unless the court otherwise orders, in both jurisdictions. But while the position in Cayman is crystal clear, in the BVI the legislation only provides that the custody and control of the assets vests in the liquidator – if a director purported to transfer company assets after liquidation had commenced, it is not clear whether a third party might still be protected by the provisions of section 31(1)(c)(ii) of the BVI Business Companies Act 2004. That provision stipulates that a company may not assert against a third party that has acquired rights or interests from the company, and that the transaction be set aside on the basis that the person claiming to be a director of the company was not duly authorised to do so (unless the third party had knowledge, or should have known through their relationship with the company, of that fact).

In the BVI, winding up only commences at the date of the relevant court order (for compulsory winding up), whereas in Cayman it ordinarily "relates back" to the date of the petition. Accordingly, in Cayman it is still possible for banks to encounter the types of issues which arose in *Re Gray's Inn Construction Co Ltd*, where, if a company continues to trade during the period after the petition has been presented but before a winding up order has been made, all the payments are potentially dispositions of property which are void unless the court otherwise orders.

But there is a much wider divergence between BVI and Cayman law in relation to the power to challenge transactions entered into in the twilight period prior to going into liquidation. There are avoidance regimes in Cayman for undervalue transactions and unfair preferences, while

the BVI also provides for the avoidance of undervalue transactions and unfair preferences (albeit with different emphasis) – but also has separate avoidance regimes for voidable floating charges and extortionate credit transactions. The distinction between both sets of litigation regimes should be noted.

In respect of transactions at an undervalue, the main distinction between the two regimes is the relevant vulnerability period. In the BVI transactions entered into up to six months before the commencement of liquidation (or two years for connected persons) may be vulnerable, but in Cayman the relevant vulnerability period is six years. In Cayman it is also necessary to show an intention to defraud in relation to the undervalue (although this is deemed to be present in the case of a related-party transaction), whereas in the BVI the mere fact of the undervalue is itself sufficient (subject to a safe harbour for transactions entered into in good faith and where there were reasonable grounds for believing the transaction would benefit the business).

Fraud and unfair preferences

When it comes to unfair preferences the two legal systems are more closely aligned, although in Cayman to challenge a transaction as a preference it must be shown that the insolvent company had an "intention to prefer" under the established common law test set out in *Re MC Bacon (No 1)*, which often operates to protect the rights of lenders who take additional security from companies in financial distress. In BVI a transaction may be vulnerable even where there is no intention to prefer – the mere fact of giving a preference is sufficient to make a transaction susceptible to challenge (although transactions entered into in the ▶

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ordinary course of business are protected). In both jurisdictions the vulnerability period is six months, although only in the BVI is this extended to two years for connected persons.

The BVI's legislation is clear that unfair preferences and undervalue transactions may only be challenged by the company's liquidator, and in the event of a successful challenge the proceeds are held for the benefit of the unsecured creditors. Cayman legislation provides that the official liquidator is the only party who may challenge an undervalue transaction, but is silent in relation to preferences (although this is probably implied from the fact that the company must have entered liquidation before a preference is capable of meeting the statutory test).

There is no express provision for any separate treatment of the proceeds of a successful application to be set aside in Cayman, although again, it is likely that the same result would be reached under the common law. Furthermore, in the BVI the title of any third party obtained for value and without notice of the undervalue or the preference is protected; this is not so in Cayman.

Separately from the insolvency regime, both the BVI and Cayman also have statutes that address transactions entered into to defraud creditors generally. In Cayman these provisions are in the Fraudulent Dispositions Law (1996 Revision), which are largely co-extensive with the undervalue transactions regime in the Companies Law; in the BVI they are in the Conveyancing and Law of Property Act 1961, and are more divergent.

Under the BVI Conveyancing and Law of Property Act, any transactions entered into to defraud creditors may be challenged by any party who is adversely affected, and there is no express time limit. However, the rights of a bona fide third party who gave value are protected.

Directors' duties

The focus of any duties that are owed by the directors of a company can change where that company enters financial distress. Under the common law rules of both jurisdictions, the duties of directors of an insolvent company (or even a company of doubtful solvency) are owed to the company for the benefit of its creditors rather than its members under well-established common law rules.

Although both jurisdictions make provision for the liability of directors and officers who have been engaged in fraudulent trading, only the former provides for statutory liability of directors engaged in insolvent trading; the directors of a BVI company may be liable to contribute to the assets available to the company's creditors if they have exacerbated the loss to creditors by continuing to trade improperly instead of putting the company into liquidation. In practice this difference is more theoretical than real, as claims based upon insolvent trading are rare in the BVI because of the logistical difficulties of bringing such claims.

While directors of both BVI and Cayman companies may be liable for misfeasance, in the BVI there are both statutory and common law provisions for liability, whereas in Cayman the matter is largely regulated by the common law.

Summary

The overall similarities are clear: both the BVI and Cayman employ robust modern insolvency regimes well suited to the needs of offshore business. However, awareness of the subtle variances between them can be crucial in potential disputes, especially where there is an insufficiency of assets to meet all of the claims against a company, which should be considered when devising appropriate offshore litigation strategies. ■

About the authors

Colin Riegels is Harneys' Global Head of Banking and Finance. His practice encompasses advising leading financial institutions and other clients on a wide range of credit and security issues. He also advises on offshore structuring and the offshore aspects of premium corporate transactions including mergers and acquisitions, disposals, joint ventures, takeovers and corporate restructurings. His recent practice has particularly focused upon insolvency and distressed debt, credit and security issues and derivatives. Colin has been involved in many of the largest financing transactions involving BVI vehicles, including a number of multi-billion US dollar debt financing transactions and joint ventures.

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Marc Kish is a Partner in Harneys' Cayman Litigation and Insolvency Department. Prior to joining Harneys in 2014, Marc worked for over five years in the litigation and insolvency department of Maples and Calder. He has advised extensively on complex large-scale liquidations and commercial litigation proceedings involving clawback actions, conflicts of law issues, fraud and related causes of action and complicated questions relating to directors' and trustees' duties and contractual interpretation. He also has extensive experience of acting in insurance coverage disputes and subrogated recoveries.

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