UPDATE

Cayman Islands Debt Restructuring

A number of recent decisions of the Cayman Islands and Hong Kong courts have placed into sharp focus the use of Cayman Islands debt restructuring tools (restructuring provisional liquidation and schemes of arrangement) in respect of cross-border debt restructurings involving Cayman Islands incorporated companies.

While the correct approach is always informed by the facts, we set out below some key points that should be considered prior to seeking to utilise restructuring provisional liquidation proceedings and / or a Cayman Islands scheme of arrangement.

What is restructuring provisional liquidation?

Cayman Islands restructuring provisional liquidation is a powerful debt restructuring tool. It allows independent officeholders to be appointed, usually on a debtor in possession basis, while granting the company a breathing space (in the form of a moratorium on unsecured creditor action in the Cayman Islands) within which to pursue a restructuring. It is also referred to as light or soft touch provisional liquidation.

How the restructuring is implemented is flexible and could, for example, involve a consensual deal with creditors, a Cayman Islands scheme of arrangement or a restructuring proceeding in another jurisdiction (for example, chapter 11 in the United States or an English or Hong Kong scheme of arrangement). The restructuring should be effected in the manner that best fits the facts.

Restructuring provisional liquidation is often used in tandem with chapter 15 of the United States Bankruptcy Code. This enables a restructuring of New York law governed debt to be given full force and effect in the United States and, where the restructuring is or may be contentious, allows the company to avail itself of a stay in the United States (which includes a stay on secured creditor action).

Entry Requirements

In order to access the restructuring provisional liquidation regime, the company must:

(a) be unable or likely to become unable to pay its debts; and

(b) intend to present a compromise or arrangement to its creditors.

The first limb is a commercial cash flow test which includes an element of futurity. How far into the future the Court can look is highly fact specific. Essentially, the Court will ask if the company is insolvent or likely to become insolvent on a cash flow basis.

The second limb has a low bar - there is no need for a company to have a formulated, or even partially formulated, a restructuring plan prior to applying to appoint restructuring provisional liquidators. The low bar enables a company to obtain the protection of the moratorium in the embryonic stages of a restructuring and negotiate with creditors within that safety net. It reflects the restructuring first mentality of the Cayman Islands

Court; giving a viable restructuring a chance to breathe.

However, while the bar is a low one, there is a bar. Evidence that the company intends to pursue a compromise or arrangement needs to be provided to the Court and the compromise or arrangement needs to concern the company to whom the application relates. It is not ordinarily possible, for example, to appoint restructuring provisional liquidators to a holding company to facilitate the restructuring of a subsidiary's debt. The Cayman Islands Court will, however, be pragmatic and commercial. Therefore, if it can be shown: (a) that, should the subsidiary restructuring be successful; then (b) a restructuring of the holding company's debt is a genuine possibility, the Cayman Islands Court could appoint restructuring provisional liquidators; even prior to the subsidiary restructuring being completed.

Evidencing an Intention to Present a Compromise or Arrangement

In order to provide the requisite evidence:

(a) the company (together potentially with the proposed restructuring provisional liquidators) at a minimum should have given proper thought (even if at a high conceptual level) to the types of viable restructuring options that could be explored and this should be properly documented for presentation to the Court; and

(b) it will usually be appropriate for the company to have had some initial discussions with the company's key creditors – where the company is insolvent or on the verge of insolvency, it is ultimately the creditors' interests that are paramount.

Notice to Stakeholders

While it is possible for the company to apply to appoint restructuring provisional liquidators without notice to the stakeholders (known as *ex parte*), careful thought should be given as to whether this is appropriate. The Court will want to know the views of creditors – the proceeding is, after all, designed to facilitate a compromise or arrangement with creditors. There should therefore usually be evidence that a core body of creditors are on-board that a form of restructuring will be viable. Consideration should always therefore be given to proceeding *ex-parte* on notice, i.e. stakeholders are notified of the application and can turn up to make representations should they so wish.

This does not mean that it is impossible to proceed on the basis that certain creditors or other stakeholders are not notified of the application. Like most things connected to company restructuring, the appropriate course of action is highly fact sensitive. For example, where a restructuring support agreement has been entered into with a good number of the company's creditors, but a small proportion of other creditors are known to be hostile, proceeding without notice to the hostile creditors can be justifiable. Notice could allow those hostile creditors to take steps to derail the restructuring before it has a chance to properly get off the ground.

It’s a restructuring - won't the Court allow officeholders to be appointed and monitor progress?

To a certain extent, the answer to the above is yes. But the Court will ask certain questions up front and the company must have the requisite answers and evidence prepared. Once the Court is satisfied that the initial bars are met, it will often make the appointment and ensure that the company and restructuring provisional liquidators are back in front of it within a relatively short period to update the Court on progress.

However, if the matters set out in the sections above are not given due consideration, this may lead to the Court sending the company away to provide further evidence (as happened in *Midway Resources*) or rejecting the application altogether. This is not efficient, particularly where a company is in financial difficulties and time is crucial. Unnecessary expense is always unfortunate – but even more so where the company does not have the money to repay its creditors.

As the Hong Kong Court recently stated in *China Bozza Development Holdings Limited*, a company cannot simply turn up before the Cayman Islands Court and use the word 'restructure' as if it were a magical incantation and expect to obtain the appointment of restructuring provisional liquidators. The bar is higher than that.

Is a Cayman Islands scheme of arrangement always necessary?

Due to the international and cross-border nature of Cayman Islands companies, the debt to be restructured is highly unlikely to be Cayman Islands law governed and the company may not have assets in the Cayman Islands. As such, it is common for the debts of Cayman Islands companies to be restructured primarily through proceedings in other jurisdictions (for example in the United States pursuant to chapter 11 or, where the company is listed on the Hong Kong stock exchange, a Hong Kong scheme of arrangement). The question then arises whether a Cayman Islands scheme of arrangement is needed to ensure that the debt restructuring is effective?

The answer will be informed by legal and practical considerations and is highly fact sensitive, but as the Hong Kong court recently pointed out in *Grand Peace Holdings Limited*, a parallel Cayman Islands scheme is not always necessary just because the company is incorporated in the Cayman Islands. The question to ask is, will the restructuring be substantially effective in the Cayman Islands without a Cayman Islands scheme of arrangement? To put it another way, is a Cayman Islands scheme needed to prevent creditors ignoring the effect of the foreign restructuring by taking action in the Cayman Islands?

In circumstances where the debt to be compromised is governed by the same law as the restructuring proceedings (for example Hong Kong law governed debt with a Hong Kong scheme of arrangement) and there are no Cayman Islands law located assets, a Cayman Islands scheme is unlikely to be necessary. This is because, as a matter of Cayman Islands law, the discharge or amendments to the foreign law governed debt obligations will be binding. Additional Cayman Islands proceedings will most likely be a waste of the company's precious resources at a time when they should be used elsewhere (e.g. in returning value to stakeholders). There is no requirement that a Cayman Islands scheme be used in every circumstance where the company whose debt is to be restructured is Cayman Islands incorporated simply because of an abundance of caution – careful consideration should be given to the facts and whether there is practically any risk to guard against. Cross-border debt restructuring should, within the relevant legal parameters, always be conducted with practicality and commerciality in mind.

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July 2021