

Appointment of Receivers over Segregated Portfolios: Clarity and Criticism

UPDATE

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The Cayman Islands Court of Appeal's decision in *Oakwise Value Fund* brings clarity to the test for the appointment of a Receiver over a segregated portfolio (SP) and affirms the flexible balance sheet approach. The decision also emphasizes the risks of not producing independent valuation evidence.

Background

The Enhanced Fixed Income SP invested in bonds issued by Chinese real estate developers. Audited accounts for the year ending 31 December 2021 showed assets of US\$750 million and minimal liabilities. However, as accepted in evidence, the value of the SP's bonds had collapsed, reaching 'rock bottom' in November 2022.

The Petitioner redeemed its investment of some US\$90 million by 1 November 2022. Redemptions were suspended from 2 November 2022 as the bond prices cratered. The Petitioner remained unpaid and petitioned for the appointment of a Receiver on 23 December 2022. The matter came on for hearing at first instance in May 2023. During the hearing, no audited accounts were made available for the year ending 31 December 2022. However, despite this obvious omission the Court dismissed the Petition, being satisfied that (i) on the evidence of management there were sufficient assets to meet the liabilities and (ii) the statutory aim of a receivership at section 224(3) of the Companies Act (2023 Revision) (the **Act**) was not met, in that a receivership would not be in the interests of investors and creditors.

The Petitioner successfully appealed all aspects of the decision.

Section 224(1) of the Act states:

'Subject to subsections (2) to (5), if in relation to a segregated portfolio company, the Court is satisfied –

- (a) that the segregated portfolio assets attributable to a particular segregated portfolio of the company (when account is taken of the company's general assets, unless there are no creditors in respect of that segregated portfolio entitled to have recourse to the company's general assets) are or are likely to be insufficient to discharge the claims of creditors in respect of that segregated portfolio; and*
- (b) that the making of an order under this section would achieve the purposes set out in subsection (3),*

the Court may make a receivership order under this section in respect of that segregated portfolio'.

Construction of section 224(1): The Test for Solvency

The arguments advanced as to the construction of section 224(1) are of little relevance. However, the findings of the Court of Appeal as to how section 224 should be construed are important. The Court of Appeal made five points:

1. First, it was confirmed that there was no basis for the argument that the test for solvency should be construed as a cashflow test. There was simply no basis to try to align the test for insolvency of a company at Part V of the Act with the test for the appointment of Receivers.
2. Second, the Court of Appeal confirmed that the test is a flexible balance sheet test. Instead of contemplating a simple assessment of the relative sides of a balance sheet, the test involves

determining whether the assets, taking into account the actual, contingent and prospective liabilities, are insufficient or are likely to be insufficient in the reasonably near future to pay the claims.¹

3. Third, the Court of Appeal confirmed that a Petitioner will be entitled to the appointment of a Receiver (subject to the Court's discretion that it 'may' as opposed to 'shall' make a receivership order under section 224(1)) if it establishes that the assets are or are likely to be insufficient to discharge the claims. One test is not more powerful than the other.
4. Fourth, the discretion at section 224(1) should only be exercised after the Court has considered whether the purpose of the order is consistent with section 224(3), which states a receiver will be appointed for the purposes of (a) the orderly closing down of the business of or attributable to the SP and (b) the distribution of the SP assets (the **Proper Purpose Test**).
5. Fifth, previous caselaw which suggested that the test would require evidence that there is no room for serious doubt that the SP is hopelessly insolvent is wrong. No such test appears in the legislation.

The Proper Purpose Test: Construction of section 224(3)

The decision that the Proper Purpose Test had not been met because '*The closing down of the business under receivers would not [...] be in the best interests of the investors/creditors*' was found to be wrong.

Perhaps unsurprisingly, the Court of Appeal made the point that section 224(3) was not concerned with the interests of the investors and creditors and hence the test had not been correctly applied. The Proper Purpose Test was clear on its face and should be applied accordingly. Any issues as to whether a receivership was or was not in the interests of investors and creditors should be dealt with when exercising the general discretion at section 224(1).

Valuation Evidence

Finally, the Court of Appeal rejected the Court's approach to the valuation evidence. There are few points of principle to be found, however the Court of Appeal made clear that (i) the views of management are no substitute for a qualified independent auditor and (ii) the Court must, of its own motion, consider the basis upon which valuations are made and properly analyse the accounts (including the notes to the accounts). Here the valuation of the bonds in the unaudited accounts were based on the cost of investment, whereas in the notes to the previous year's audited accounts, it was clear the bonds had been valued at fair value using reputable pricing sources.

Conclusion

In all, the decision at first instance received much criticism and highlights what a thankless task judging can be. However, this decision should, at least, settle some of the more outlandish arguments as to the proper interpretation of section 224 and should encourage those defending such petitions to put forward cogent and, if possible, independent valuations when seeking to persuade the Court that there are sufficient assets to satisfy a debt.

¹ The test is designed to be more flexible than a straightforward balance sheet test so as to mitigate the difficulties creditors might have in accessing the necessary financial information.

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