LEGAL INSIGHTS

CAYMAN COURT RULES ON THE TEST OF INSOLVENCY FOR RECEIVERSHIP OF A SEGREGATED PORTFOLIO OF AN SPC

The Grand Court in the Cayman Islands recently confirmed the appropriate insolvency test to be applied pursuant to section 224 of the Companies Act (2021 Revision) ("**Companies Act**") in respect of a Cayman Islands segregated portfolio company ("**SPC**"), in a judgment delivered in respect of Obelisk Global Fund SPC ("**Fund**") and Obelisk Global Focus Fund ("**SP1**").

1. Segregated portfolio companies

An SPC is a single legal entity, which can create an unlimited number of separate segregated portfolios. The assets and liabilities of a segregated portfolio benefit from a statutory "ring-fence" from the assets and liabilities of (i) any other segregated portfolios of the SPC and (ii) from the general assets and liabilities of the SPC, under section 216 of the Companies Act. Given the flexibility of the corporate structure, ability to prevent cross-liability issues between different segregated portfolios and to pursue a different investment strategy for each segregated portfolio, the SPC is a very popular Cayman Islands investment vehicle for multi-class and/or multi-strategy investment funds. Please see our Briefing Note Benefits of Segregated Portfolio Companies for investment purposes for further details.

2. Facts of the Case

The Fund is registered with the Cayman Islands Monetary Authority as a mutual fund. Obelisk Capital Management Ltd. (in official liquidation) ("**Investment Manager**") is the Cayman Islands investment manager which provided (i) investment management

services to segregated portfolios of the Fund, (including SP1) and (ii) operated the sourcing and pre-financing of gold doré from mines in East and West Africa. The Investment Manager was placed into official liquidation on 26 June 2020.

The Fund on account of SP1 is indebted to the Investment Manager in the sum of approximately US$55,000 pursuant to a loan transferred by the Fund to SP1 on 6 May 2019 ("**Debt**").

The joint official liquidators of the Investment Manager demanded payment of the Debt and issued a statutory demand on SP1 on 10 February 2021 in respect of the Debt, which was acknowledged but not paid by SP1. The Investment Manager sought a receivership order from the Grand Court in respect of SP1, on the basis of SP1's insolvency.

3. Key statutory provisions

The winding-up procedures set out in Part V of the Companies Act apply in respect of a "company", therefore as a segregated portfolio does not have a separate legal personality to the SPC, the statutory modes of winding-up which are available to a company, cannot apply to a segregated portfolio on its own. However, receivership allows a specific segregated portfolio to be closed down without the overall SPC structure having to be wound-up.

Section 224 of the Companies Act sets out the grounds for the appointment of a receiver over a segregated portfolio of an SPC. The key provisions are summarized as follows:

a. Section 224(1) of the Companies Act provides that the Court may make a receivership order in respect of a segregated portfolio if the Court is satisfied:

i. “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

ii. the making of a receivership order would achieve the purposes of “the orderly closing down of the business of or attributable to the segregated portfolio” and “the distribution of the segregated portfolio assets attributable to the segregated portfolio to those entitled to have recourse thereto.”

b. Section 224(2) of the Companies Act states that a receivership order may be made in respect of one or more segregated portfolios.

4. Balance sheet test v cash flow test?

SP1 did not dispute the fact that the Debt is owed by SP1, the quantum of the Debt or that the sum of the Debt is above the statutory minimum for a statutory demand pursuant to section 93(a) of the Companies Act.

However, counsel for SP1 opposed the receivership application in respect of SP1, on a number of grounds, including that it had not been shown that SP1 “has or is likely to have insufficient assets to meet the claims of its creditors”. It was also argued that if SP1 is deemed to be “balance sheet solvent” in the long term, the Court may not make an order for the appointment of a receiver.

Counsel for the Investment Manager argued that the relevant test for insolvency must either be by reference to a “cash flow test” or “balance sheet test” and submitted to the Court that a cash flow test should be used.

a. Cash flow test: a company is deemed to be insolvent under the cash flow test if it cannot pay the debts that are due at present, or if on the balance of probabilities, it does not or will not have the resources to discharge those debts that will fall due in the reasonably near future.

b. Balance sheet test: a company is insolvent under the balance sheet test if its assets do not exceed its liabilities, taking into account contingent and prospective liabilities.

Counsel for the Investment Manager argued before the Court that there is no case in the Cayman Islands Court of a petitioner having to prove that an entity is balance sheet insolvent. Furthermore, it was argued that a balance sheet test would bring up evidentiary issues for a petitioner (i) as a creditor would not usually have access to the books and accounts of the applicable company (especially in respect of a Cayman Islands company, for which there is no legal requirement to make accounts publicly available) and (ii) the valuation of assets is not an easy matter, even if a creditor has access to the relevant information.

5. The Court's Decision

As the Debt was settled before the judgment in this case was delivered, the judgment only covered the jurisdictional aspects of the application for receivership of the Segregated Portfolio by the Investment Manager.

The Judge in the case, Justice Raj Parker, did not accept that the wording in section 224(1) of the Companies Act equates to a cash flow test of insolvency – in particular, it was noted that no language as to debt and timing of payment is included within this sub-section.

The Court ruled that on a plain reading of section 224 of the Companies Act:

a. the test as to whether the Court has jurisdiction to make a receivership order in respect of a segregated portfolio is whether the assets of a company are or are likely to be sufficient to discharge the claims of creditors, which can be regarded as its liabilities i.e. a balance sheet test, rather than a cash flow test; and

b. this involves a determination on the available evidence of whether the assets are sufficient at present or are likely to be in the reasonably near future when assessed against its liabilities (including prospective and contingent liabilities) and are held in a form where they may be used to pay the claims of creditors.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice on Segregated Portfolio Companies, please contact your usual Loeb Smith attorney or :

Elizabeth Kenny
Senior Associate
Tel: +1 (345) 749 7594
E: elizabeth.kenny@loebsmith.com

About Loeb Smith Attorneys

Loeb Smith is an offshore corporate law firm, with offices in the British Virgin Islands, the Cayman Islands, and Hong Kong, whose Attorneys have an outstanding record of advising on the Cayman Islands' law aspects and BVI law aspects of international corporate, investment, and finance transactions. Our team delivers high quality

Partner-led professional legal services at competitive rates and has an excellent track record of advising investment fund managers, in-house counsels, financial institutions, onshore counsels, banks, companies, and private clients to find successful outcomes and solutions to their day-to-day issues and complex, strategic matters.