

# LEGAL ALERT

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## Shareholder Disputes and Corporate Insolvency: Applications for Validation Orders by solvent companies and exempted limited partnerships following the laying of petitions for their winding-up on just and equitable grounds

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### Introduction

On 9 February 2016, Clifford J., sitting in the Financial Services Division of the Grand Court of the Cayman Islands gave Judgment in *In Re Torchlight Fund L.P. (unreported)* reaffirming the principles which the Court will take into account in determining whether to grant a validation order. This article seeks to provide a summary of these factors, which will be of particular interest to the directors of a solvent company or the general partner of a solvent exempted limited partnership against whom a petition for winding-up has been made but not yet granted. This typically arises where shareholders or limited partners are in dispute with the management of the entity and have filed a petition on just and equitable grounds. It should be noted that pursuant to section 95(3) of the Companies Law (2013 Revision) (the “**Law**”), upon the presentation of a petition on such grounds, the Court has a number of alternative remedies available to it other than insolvency and include, for example, an order regulating the conduct of the entity’s affairs in the future (s.95(3)(a)).<sup>1</sup>

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<sup>1</sup> The provisions relating to the winding-up of companies under Part V of the Law apply (with a few exceptions) to exempted limited partnerships pursuant to s.36(3) of the Exempted Limited Partnership Law, 2014.

## What is a “validation order”?

A validation order is one made pursuant to section 99 of the Law which provides as follows:

*“When a winding-up order has been made, any disposition of the company’s property and any transfer of shares or alteration of the status of the company’s members made after the commencement of the winding up is, unless the Court otherwise orders, void.”*

By section 100(2) of the Law, the winding-up of a company, and by extension an exempted limited partnership, is deemed to commence at the time of the presentation of the petition to the Court for winding up. As a consequence, directors and general partners need to take care that they do not fall foul of section 99 of the Law in the twilight between the presentation of the petition for winding up to the Court and the granting of the winding-up order by the Court, for which they may become personally liable.

It is therefore common for executives of solvent entities to apply to the Court for a prospective validation order in respect of payments and dispositions which are to be made in the ordinary course of business and in order to enable the entity to continue trading in the interim.

### The test following *In Re Torchlight Fund L.P.*

Clifford, J., reviewed the authorities in the area which have their origin in relation to the interpretation of equivalent statutory provisions at English law.<sup>2</sup> The learned Judge cited the dicta of Henderson, J., in the Grand Court in *In Re Fortuna Development Corporation [2004-2005] CILR 533* in which the Court held that *“there are four elements which must be established before an applicant is entitled to a validation order”*. These may be summarised as follows:

- (1) the proposed disposition must appear to be within the powers of the directors;
- (2) the evidence must show that the directors believe the disposition is necessary or expedient in the interests of the company;
- (3) it must appear that in reaching the decision the directors have acted in good faith (the burden

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<sup>2</sup> See, for example, *Re Burton & Deakin Ltd* [1977] 1 All ER 631 and *Re a company (No 005685 of 1988), ex parte Schwarcz and another* [1989] BCLC 424 (both cited by Clifford, J., in his learned Judgment).

of establishing bad faith is on the party opposing the application); and

- (4) the reasons for the disposition must be shown to be ones which an intelligent and honest director could reasonably hold.

Clifford J. held that these elements:

*“have to be established by evidence, even if this has the effect in relation to the third element, of shifting the burden of establishing bad faith on the party opposing the application. There has to be a body of evidence relevant to the required elements for the Court to consider in exercising its discretion.”*

In *In Re Torchlight Fund L.P.* the partnership’s evidence was found to be insufficient for these purposes. For example, the partnership failed to produce specific information concerning the inflow of money and details of the proposed payments to be made. In that case, the Petitioners were particularly concerned about payments being made to related parties.

#### **A fifth element – irregularities in the affairs of the entity**

Clifford J., went on to note that these four “elements” had been taken a stage further by the Chief Justice of the Grand Court in *In Re Cybervest Fund* [2006] CILR 80 in which the Court had refused to make a validation order in respect of management fees on the footing that, where there could be shown to be irregularities in the conduct of the company’s affairs, it by no means followed that because the company was solvent and able to pay its debts as they fell due the conduct of the company’s business should be continued, potentially at the expense of its investors. The Chief Justice held:

*“There is another consideration to add to this list, in light of the concerns raised in the matter, although arguably it is subsumed within the third and fourth elements. This would be whether irregularities in the conduct of the affairs of the company can be shown, even if the company is clearly solvent, as is alleged here.”*

Indeed, in both *In Re Cybervest Fund* and *In Re Torchlight Fund L.P.*, the Grand Court that those cases concerned irregularities in the conduct of the affairs of the company and exempted limited partnership respectively which went to the very core of the question of what can properly be regarded as being in the ordinary course of business that it would not be proper to make a general validation order in the form sought.

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