

UPDATE

# Validation Orders: Preserving the Status Quo

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In a recent decision<sup>1</sup> the Cayman Islands Court of Appeal (the **CICA**) considered the use of validation orders under section 99 of the Companies Law (2018 Revision) (the **Law**) to allow for the trading of shares on the Hong Kong Stock Exchange while a petition for the winding-up of the company is pending. In overturning the Grand Court's decision to grant a validation order, the CICA held that any validation order made must not undermine or frustrate the maintenance of the status quo in the company pending resolution of the winding-up petition.

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China Shanshui Cement Group Limited (the **Company**) is the parent company of a group of companies engaged in the production of cement in mainland China. Its major shareholders, Tianrui International Holding Company Limited (**Tianrui**), Asia Cement Corporation (**ACC**) and China National Building Material Holding Company (**CNBM**) are involved in a bitter take-over battle for the Company. Tianrui presented a petition to wind up the Company on just and equitable grounds, alleging that ACC has been acting improperly in concert with CNBM to dilute Tianrui's shareholding and squeeze it out of the Company. The Grand Court (the **GC**) has yet to hear the winding-up petition.

It was alleged that the dilution of Tianrui's shareholding was achieved by an improper exercise by the directors of their powers to issue securities through the successive issuing of convertible bonds to bondholders with whom ACC and CNBM were associated or connected. The convertible bonds were subsequently converted into shares. The Company sought validation of a proposed transfer of shares in the Company to the Hong Kong Securities Clearing Company Nominees Limited (**HKSCC**) to facilitate the trading of those shares through the Central Clearing and Settlement System (**CCASS**). The CCASS indicated that, before it would accept the deposit of shares, it required that the Cayman Court to validate the transfer of legal title to HKSCC under section 99 of the Law. A validation order made in respect of the transfer of legal title in the shares to HKSCC, and the subsequent deposit into the CCASS, would safeguard those transactions from being unwound under the avoidance provisions contained in section 99 of the Law, in the event of the Petition being successful.

## Section 99 of the Law

Section 99 of the Law provides that *when a winding up order has been made, any disposition of the company's property and any transfer of shares or alternation in the status of the company's members made after the commencement of the winding up is, unless the Court otherwise orders, void.*

A winding-up petition is deemed to commence on the date of its presentation. Once a petition has been presented, any transaction, such as the proposed transfer of shares to HKSCC or the alteration in the status of the company's members, will be void (so as if it had never occurred) if the winding-up order is ultimately made unless the court exercises its discretionary power under section 99 of the Law to validate the transaction. Section 99 allows a liquidator to ignore transactions that have taken place during this period as

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<sup>1</sup> *Tianrui (International) Holding Company Ltd v China Shanshui Cement Group Limited* (unreported, 18 February 2020).

legally ineffective, and so return the company to the position it was in at the commencement of the winding-up.

### **The Decision of the Grand Court**

In granting the validation order, the GC applied the legal test in *Burton v Deakin Ltd* [1977] 1 WLR 390 (followed in *Fortuna Development Corporation* [2004-5 CILR 533]): were the reasons for the transaction those which an intelligent and honest director could reasonably hold in good faith and which had a clear commercial basis? The GC accepted that the Company's proposed transfer was the result of its wish to reduce the illiquidity of its shares and that the application for a validation order prompted by HKSCC's request for validation. The GC held that the transfer of legal title in the shares did not run afoul of the rationale of section 99 of the Law and so granted the validation order (the **Validation Order**).

### **The Decision of the Court of Appeal**

On appeal, the CICA reversed the decision of the GC and held that the purpose of section 99 is to preserve the status quo in the company by preventing the improper alienation or dissipation of the property of a company during the period between the presentation of a winding-up petition and its determination so all of the company's assets are available to the liquidator on appointment. However, it is also important that companies are able to continue to operate in the ordinary course of their business prior to the determination of the petition. The court's ability to validate transactions during this period allows for the company to keep 'ticking over' by conducting its business in a manner which enables it to survive notwithstanding a pending petition. The validation process mitigates the potentially harmful effects of the presentation of a petition prior to its determination.

The CICA confirmed that a court, in every case, must satisfy itself that any application for a validation order does not undermine or frustrate the maintenance of the status quo pending resolution of the petition. To the contrary, the order should be made in furtherance of that objective. This principle should not alter according to the particular circumstances of the case, but its application will vary from case to case. The principle applies equally to solvent and insolvent companies and the court should not consider itself relieved of the responsibility of careful scrutiny and caution merely because the company in question is solvent.

The CICA considered that the real danger of the approach taken in *Burton* and *Fortuna* is that it focuses on the burden of proof and creates a presumption in favour of the belief of the directors as to the propriety of their proposals. In every case, those seeking a validation order must be able to satisfy the court that what is proposed will not undermine the avoidance function of section 99 of the Law and will not impede or frustrate the unwinding of transactions after the presentation of the petition. Where the proposal is made for the purpose of the ordinary course of business the court will more readily take the view that there is no unacceptable risk to the maintenance of the status quo. In such a case the views of the directors as to whether the proposals are for the benefit of the company will be relevant but not dispositive.

CICA considered that insufficient explanation had been given for why the shareholders wanted to deposit their shares into CCASS or why the Company wanted to increase liquidity in order to raise capital. In the absence of any response, the CICA concluded that there was no reasonable explanation for the transaction, other than that proffered by Tianrui, namely that the deposit with CCASS was intended to prevent the conversion of bonds into shares, which took place after the presentation of the winding-up petition, from being unwound. For those reasons, the CICA overturned the GC's decision and refused to make the Validation Order.

### **Conclusion**

This decision confirms that careful scrutiny and caution will be applied to an application for a validation order under section 99 of the Law. The Court must satisfy itself in every case that any order it makes does not undermine or frustrate the maintenance of the status quo in the company pending resolution of the petition.

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