UPDATE

JULY 2020

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Checking the Lifeboat - Cayman Islands Consensual Restructuring Strategies

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The Cayman Islands is the preeminent offshore jurisdiction for corporate, fund and finance vehicles. It is also a creditor friendly jurisdiction, where properly constituted security has statutory protection from the reach of liquidators. We explore some of the options available to lenders and companies when navigating troubled waters.

1 Introduction

In order for a Cayman Islands entity to avoid the risk of being wound up on the ground it is insolvent, it must be able to pay its debts as they fall due in the ordinary course of business. The cash flow solvency test involves having some regard to debts which fall due for payment in the reasonably near future as well as debts which have already fallen due.[1] As to what future debts are deemed as falling due in the 'reasonably near future', that is a question to be determined on a case-by-case basis depending on all of the circumstances, and with reference to the underlying business of the company. This is ground zero for any Cayman Islands restructuring strategy, outside of formal insolvency proceedings.

If it is not possible to satisfy the cash flow solvency test, it may be necessary to resort to formal insolvency proceedings to provide sufficient breathing space to explore and negotiate a potential restructuring. The Cayman Islands has a sophisticated statutory scheme of arrangement process which can be used in these circumstances.

This update focuses on restructuring outside of formal insolvency proceedings. The strategy adopted, and combination of tools that are appropriate obviously varies depending on the particular fact pattern.

2 Keeping Afloat – Super Priority Financing

A distressed business may well need access to additional working capital to stay afloat. This 'new money' when forthcoming, tends to be provided by a subset of lenders (often the key relationship lenders). From a Cayman Islands perspective, those lenders ought to consider:

- ***Desired priority ranking:*** to minimise the risk of 'throwing good money after bad', the lenders will typically require this new money financing to be super-senior secured, that is, ranking ahead of existing (pre-restructuring) senior debt. The default position under Cayman Islands law is that unsecured and unsubordinated debt obligations rank pari passu on a debtor company's insolvency – which is unlikely to be acceptable. As a result, an intercreditor agreement is key as Cayman Islands law permits the default position to be modified by contract;
- ***Collateral agency:*** Cayman Islands law allows for a single collateral agent under an intercreditor agreement to hold the benefit of any common security on trust for multiple secured parties (ie, there is no requirement for '*parallel debt*' provisions as is the case in some jurisdictions);
- ***Reliance on existing security:*** it is not always the case that the existing security package can support the new debt obligations without amendment or replacement. When a lender is considering loan

[1] *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL PLC*

extensions or variations and the new loan obligations are different in nature or purpose to what the security package was originally intended to support, it is important to consider putting in place a new security package - even where the existing security documentation is expressed to extend to amendments or replacements; and

- ***Perfection of new security:*** any new security interests granted with respect to Cayman Islands situated collateral must be properly perfected. The Cayman Islands has no public registration regime equivalent to the UCC in the United States or Companies House in England and Wales. Rather, specific steps will be required depending on the asset type in question. These may include registration at a specific register (for moveable assets such as ships and aircraft) or notice to counterparties (in the case of intangible assets such as contractual rights).

3 Standstill agreements

Negotiated standstill agreements with key financial creditors are a common feature of out-of-court restructuring processes. These may be critical to the business continuity strategy, and are relevant in the Cayman Islands context as follows:

- ***Automatic stay:*** under Cayman Islands law, an automatic stay imposed by a foreign bankruptcy regime (such as U.S. Chapter 11) will not generally extend to Cayman Islands debtors, unless that relief is specifically sought from the Cayman courts. Further, even if a stay is granted by the Cayman court, it will not prevent secured creditors enforcing security over the debtor's collateral;
- ***Insolvency set off:*** Cayman Islands law provides for automatic set-off of mutual debts upon insolvency and will also recognise and enforce contractual netting arrangements. Therefore, in a scenario where the parties wish to modify this basic position or prevent certain creditors (such as hedge counterparties) from taking full advantage of mutual set off or netting arrangements, that will need to be addressed in the relevant standstill agreement; and
- ***No cram down:*** in an out-of-court context, there is no statutory 'cram down' mechanism which can be used to bind unwilling creditors (this option only being available pursuant to a Court supervised scheme of arrangement). This means that any given standstill agreement must work for all creditors who have been identified as crucial to the viability of the restructuring.

4 Debt for equity swaps

Lenders may agree to exchange all or some of their loans for equity in the debtor company. In this context:

- ***Terms of issue:*** Cayman Islands law generally allows companies to issue shares on flexible terms, including preferred shares and shares redeemable upon the occurrence of a specified event (or at the option of the holder or the company). This is however subject to the terms of the company's memorandum and articles of association. In particular, where a new class of shares are being created with preferred rights, the requisite consent of the existing shareholders may be required; and
- ***Anti-dilution:*** shareholders do not have statutory anti-dilution or pre-emptive rights by default under Cayman Islands law. Again however, this position may be modified under a company's memorandum and articles, which will need to be reviewed in each case for any necessary shareholder consents or waivers.

5 Golden shares

Golden Shares were first used by the British Government to exercise certain controls over newly privatised companies. The concept is equally applicable for a lender seeking additional control or comfort, especially where it has particular risk concerns.

A golden share may be created pursuant to a directors' resolution and without further shareholder consent, however this depends on the particular terms of the articles of association of the debtor company. The golden share is issued to the lender or its nominee.

The terms of the golden share may encompass a variety of different veto controls. A lender may be concerned the constitutional documents of the debtor company are amended to remove protections the lender has specifically negotiated, or that assets of the debtor company (or a subsidiary group company) are transferred, sold or pledged in circumstances without the lender's knowledge or prior consent. A golden share may also provide a lender with an enshrined corporate right to have its nominee attend board of directors meetings and ask questions. For a golden share to be effective, the scope and application of its rights ought to be stipulated with utmost clarity.

6 Distressed asset sales / spinoffs

A distressed business may carry out asset sales in tandem with, or as a pre-requisite to, a debt restructuring. The goal may be to generate liquidity, allow debt to be repaid and/or streamline the business. In a Cayman Islands context, some considerations include:

- ***Corporate benefit:*** similar to other common law jurisdictions, the directors of a Cayman Islands company are required to act in the best interests of the company. When the company's solvency is threatened, Cayman Islands law recognises that focus will shift from a company's shareholders to the interests of its creditors. However, because this may encompass a wide group of creditors taken as a whole, directors will still need to satisfy themselves that the company is receiving fair value or that the disposal is otherwise justifiable. Here, the directors might consider the extent to which the disposal is a pre-condition to ongoing support from key financial creditors;
- ***Voidability risk:*** undervalue transactions and voidable preferences remain subject to being unwound by a liquidator if made within a period of time prior to the commencement of the liquidation (six months for voidable preferences and six years for dispositions at an undervalue). However, this will only be the case if the company is insolvent at the time and the intent of the transaction was to prefer a certain creditor or creditors (for preferences) or with the intention of defrauding a creditor (for dispositions at an undervalue). As noted above, the solvency test focuses on the company's ability to pay debts as they fall due (ie cash flow solvency), and does not turn on balance sheet solvency. Therefore, in the context of a managed workout involving sophisticated parties which has a genuine commercial purpose, the voidability risk can usually be expected to be low; and
- ***Security releases:*** at the closing of the disposal, any Cayman Islands law security over assets (or over shares in the entity subject of the disposal) will likely need to be released. While this release need not strictly be governed by Cayman Islands law, some attention should be paid to terminology (for instance, contractual rights which have been assigned by way of security will technically require "re-assignment" to the debtor). The applicable registers detailing particulars of the security should also be updated to reflect the discharge of obligations.

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