Cayman Islands' Companies (Amendment) Act, 2021 Introduces A New Corporate Restructuring Regime - Positive Implications for the Cross-border Restructuring of Chinese-invested Companies

By Yuhua Yang | Amy Ren | Shawn Xu | Kaiwei Xiao | Rebecca Hume (Gateley)

Preface

Over the years, many Chinese companies have registered corporate entities in the Cayman Islands ("**Cayman**") driven by considerations in respect of investment, financing, tax planning, trade, etc. Cayman's legal framework has provided investing and financing opportunities for a large number of onshore companies, including facilitating Chinese companies listing on the mainstream international stock exchanges, setting up special purpose vehicles, establishing investment funds, etc.

The Companies Act has been playing a vital role in Cayman's legal framework. On 31 August 2022, the Companies (Amendment) Act, 2021 [1] ("**Amendment**") came into force. It introduces a new corporate restructuring regime. The establishment of such a new restructuring regime provides a clear legal basis for facilitating the cross-border restructurings in Cayman, which is of positive significance for Chinese-invested companies when cross-border restructuring is in demand.

1. Background

Prior to the Amendment, Cayman did not have a restructuring regime that was similar to the UK's administration procedure, or procedure under Chapter 11 of the U.S. Bankruptcy Code. A company in financial distress seeking the protection of a debt moratorium had to present a winding-up petition, and only with

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[1] http://gazettes.gov.ky/portal/pls/portal/docs/1/13132651.PDF

the appointment of provisional liquidators could it obtain the benefit of a “breathing space” and defer the repayment of debts. After the hearing of a winding-up petition, the Cayman court could make a court order appointing a provisional liquidator to facilitate a compromise or arrangement with the company’s creditors. This could be by way of a scheme of arrangement for the company’s restructuring. A winding-up petition alone does not automatically trigger a debt moratorium. It can only render dispositions of the company’s property between presentation and the making of a winding up order void.

It was recognised that the use of “soft” or “light touch” provisional liquidation to facilitate a restructuring is a hard sell because liquidation is synonymous with the death of a company rather than its survival.

The changes to the Cayman restructuring regime are intended to create a proper restructuring process that is fit for purpose.

The Amendment was published at the end of last year and recently came into force on 31st August 2022. Amendments to the Companies Winding Up (Amendment) Rules, 2022, which govern practice and procedure in insolvency proceedings, took effect on the same date.

2. Brief Introduction of the New Restructuring Regime

2.1 Commencement of Restructuring

A company may present a petition to the Grand Court of the Cayman (the “**Cayman Court**”) for the appointment of a restructuring officer (“**RO**”) who must be a qualified insolvency practitioner, on the grounds that the company (a) is or is likely to become unable to pay its debts; and (b) intends to present a compromise or arrangement to its creditors either, pursuant to the amended Companies Act, the law of a foreign country or by way of a consensual restructuring. Such a petition is the commencement of the company’s restructuring. The directors of a company may now present a petition on the company’s behalf without a resolution of its members or an express power in its articles of association. This greatly reduces the difficulty of initiating a restructuring and encourages companies to pursue a restructuring in a timely manner.

2.2 Restructuring Officer

a. Appointment, Variation and Discharge, Removal and Replacement

As mentioned above, a petition seeking the appointment of a RO may be presented by the directors of a company, and the Cayman Court may, on hearing the petition, decide whether to make an appointment order. Pending the petition being heard, a company may make an *ex parte* application to the Cayman Court for the appointment of a RO on an interim basis. Such application may be heard without notice. This is particularly important where the company is experiencing severe creditor pressure and the time for proposing any compromise or arrangement is of the essence.

After the appointment of a RO, the RO, the company, the creditors, the company's contributories and the authority, in respect of any company which is carrying on regulated business, may apply by way of summons to the Cayman Court for the variation or discharge of the order appointing the RO. Similarly, based on the application of the above-mentioned parties (except the RO itself), the Cayman Court may decide on the removal and replacement of the RO and require the outgoing RO to prepare a report and accounts within a certain period of time in order to ensure a smooth transition of work.

b. Requirements for a RO

Under the new restructuring regime, a RO shall be a qualified insolvency practitioner and serve as a court officer. Where two or more persons are appointed as ROs, they shall be authorised to act jointly and severally. Notably, the new restructuring regime provides foreign insolvency practitioners with access to participate in the restructuring. A foreign practitioner may be appointed to act as a RO, but not as the sole RO of a company. In addition, the new restructuring regime has established a dispute resolution mechanism where a RO, a creditor of the company (including a contingent or prospective creditor), or a contributory of the company may apply to the Cayman Court to determine any issues arising in the course of RO carrying out its duties.

2.3 Automatic Stay and Extraterritorial Effect

The petition for the appointment of a RO will result in an automatic stay or moratorium on creditor actions. No suit, action or other proceedings (other than criminal proceedings) may be commenced against or proceeded with the company, except with the leave of the Cayman Court. China has adopted a similar mechanism in the *Enterprise Bankruptcy Law of the People's Republic of China* (《中华人民共和国企业破产法》): upon the court acceptance of an insolvency petition, a stay on the existing litigation and enforcement shall apply, and application for litigating or enforcing the debt settlement shall be inadmissible.

Under Cayman law, the aforementioned automatic stay or moratorium is purported to have extraterritorial effect and will apply to any suit, action or other proceedings outside the Cayman jurisdiction. Some foreign jurisdictions may not, however, recognise the stay or moratorium without the company obtaining recognition of the Cayman restructuring proceedings in that jurisdiction. Accordingly, it is important to check whether additional steps might need to be taken in those jurisdictions where the company may be experiencing creditors' pressure.

2.4 Enforcement of Creditor's Security

The Amendment provides that a creditor who has security over the whole or part of the assets of the company is entitled to enforce the creditor's security without the leave of the Cayman Court and without reference to the RO appointed. In comparison with China's position under Chapter 8

"Restructuring" of the *Enterprise Bankruptcy Law* which provides that the exercise of the security rights by the secured creditors shall be suspended during the restructuring. Cayman's new restructuring regime reflects its secured creditor-friendly nature.

2.5 Voting in Scheme of Arrangement

Where a RO is appointed and a compromise or arrangement is proposed, the Cayman Court may, on the application of the RO, order a meeting of the members of the company or class of members, or of the creditors or class of creditors, as the case may be, to be summoned in such manner as the Cayman Court directs.

A scheme of arrangement is subject to a 75% voting threshold for members and creditors. It is important to note that the "headcount test" for **members'** voting has been abolished under both Section 86 and Section 91 of the newly amended Companies Act such that only the "majority in value" test is required to be satisfied. However, for the **creditors**, the "headcount test" still applies. If a scheme of arrangement obtains the required votes and has been sanctioned by the Cayman Court, it shall be binding on the company, on all the members or class of members (as the case may be), and on all the creditors or the class of creditors (as the case may be). Recognition of the scheme or arrangement may also be sought in foreign jurisdictions to ensure smooth execution of the proposed restructuring.

2.6 Reconstruction and Amalgamation of Companies

The provisions for facilitating reconstruction and amalgamation of companies under the new restructuring regime are consistent with those in the previous provisional liquidation regime. The Cayman Court may, on application, make a range of provisions for the reconstruction or amalgamation of companies for the purpose of or in connection with schemes of arrangement. Among other things, where an order provides for the transfer of property or liabilities, the property and liabilities shall be transferred to the transferee company. Such property shall be freed from any charge which is, by virtue of the scheme of arrangement, to cease to have an effect.

3. The Implications for the Chinese Companies in Financial Difficulties

Under Cayman's new restructuring regime, we believe that relevant Chinese companies may take advantage of the new regime to alleviate their debt pressure and facilitate corporate restructuring.

3.1 Asset Preservation and Coordinated Restructuring

The automatic moratorium or stay on the unsecured creditors' action upon a petition for the appointment of RO(s) under the new regime is important for the debtor's asset preservation. Nonetheless, the extraterritorial effect of such a stay as a matter of Cayman law may not be recognised in certain foreign jurisdictions. According to current judicial practice in China, restructuring proceedings initiated by a debtor outside of China cannot be a direct cause for the release of the debtor's attached property in China or the stay of enforcement proceedings.

At present, there has been no bilateral or multilateral international treaty between China and Cayman[2]; China has not adopted the UNCITRAL Model Law on Cross-Border Insolvency (https://uncitral.un.org/zh/texts/insolvency/modellaw/cross-border_insolvency). The recognition of foreign-initiated insolvency proceedings by the Chinese courts is rather scarce. As such, it is difficult, if not impossible, to obtain the Chinese court's recognition of Cayman proceedings. Nevertheless, China is taking efforts to establish mechanisms of recognition and assistance in insolvency proceedings. For example, the Supreme Court of Mainland China and the Government of the Hong Kong Special Administrative Region ("**HKSAR**") signed the *Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the courts of the Mainland and the HKSAR* (《关于内地与香港特别行政区法院相互认可和协助破产程序的会谈纪要》) in May 2021, marking the first bilateral protocol which provides for cross-border insolvency assistance in China.

Considering the importance of the China jurisdiction and the status quo reality of lacking international judicial collaboration, from a practical point of view, it is advisable for both the debtors and creditors to closely monitor the financial situation of relevant China operating subsidiaries/affiliates and the conditions of their respective key assets, as well as the onshore legal proceedings in the mainland China. China-related restructuring has to be planned strategically with various tactical measures coordinated as early and as much as possible to ensure, to the maximum possible extent, the desired outcome. Though it is never an easy task, in practice, a good strategy equipped with carefully planned legal tactics may achieve a significant advantage. In a cross-border scenario, like it or not, the jurisdictional barrier is a double-edged sword.

3.2 Debt Settlement and Foreign Practitioner's Participation

Generally speaking, Chinese companies set up their Cayman entities mainly under two types of structures——the equity ownership structure or the variable interest entity ("**VIE**") structure where equity control is not feasible due to the relevant foreign investment restrictions under Chinese law.

A typical Chinese-style VIE structure involves the Chinese beneficial owners incorporating a Special Purpose Vehicle ("**SPV**") in Cayman, which serves the financing purpose and is potentially a listing vehicle, then, through layers of BVI and Hong Kong SPVs, establishing a wholly foreign-owned enterprise ("**WFOE**") in Mainland China. Such WFOE and a China-based operating entity ("**OpCo**")[3] are

[2] Cayman does have legislation for the recognition of foreign insolvency proceedings the wording of which is not dissimilar to the UNCITRAL Model Law. So as long as the foreign proceeding is a collective insolvency proceeding, which has come into being as a result of a court order and it doesn't offend Cayman public policy recognition is likely to be granted. When it comes to Chinese restructuring proceedings there is a risk that the Cayman court won't recognize them if local Chinese creditors are given preference over other creditors especially if there are creditors in Cayman.

[3] OpCo normally operates regulated business in China with foreign investment forbidden or severely restricted. As such, OpCo cannot be foreign owned.

connected through a package of contractual agreements ("**VIE Agreements**") to channel the funding and economic return between the WFOE and the OpCo, meanwhile the VIE Agreements will set forth management and control measures to safeguard corporate governance and effective decision-making process as well as necessary investment protection mechanisms[4].

For most, if not all, Chinese companies, the Cayman-centric offshore structure has been created to serve the international financing and listing purpose, and business substance is in mainland China and various other onshore jurisdictions where the business is operated. From an international investor and/or creditor's perspective, a standalone Cayman restructuring of a Chinese VIE or equity structured business is unimaginable. On the other hand, Cayman is also inevitable for the listed or unlisted Chinese businesses which have benefited from Cayman structured financing.

Considering the complex shareholding structure and debt structure, restructuring such companies can never be easy. The new Cayman restructuring regime is a debtor-in-possession regime which can offer more space and flexibility for the stakeholders to design an effective restructuring plan. Directors of the company can present a petition for the appointment of a RO on the company's behalf, without seeking a members' resolution, making the process easier and faster than before. Additionally and notably, the new regime allows foreign insolvency practitioners to act as ROs. The potential participation of Chinese insolvency practitioners, who are more familiar with the Chinese legal and regulatory environment as well as Chinese business practice, is likely to facilitate and potentially gain a better chance to achieve a practical and successful restructuring.

3.3 Business Restructuring

In addition to debt settlement, the more meaningful restructuring inevitably involves business restructuring. Chinese companies may take advantage of the provisions for facilitating the reconstruction and amalgamation of companies as set forth in the newly amended Companies Act to achieve supply chain and resource integration through business restructuring.

Our observation shows that large-scale restructurings on the market normally leverage a few key market players' financial difficulties and lead to reshaping a particular industry sector strategically such as supply chain extension, vertical and/or horizontal integration, enhancing core competitiveness and redefining corporate value. Chinese companies intend to plan and identify the key factors that are relevant and have an impact on the whole regime, then formulate a pragmatic growth strategy, stick to their business niche, and concentrate resources in certain profitable or sustainable areas, to avoid sinking into financial distress again. The new Cayman regime offers a more friendly approach and may equip those business restructuring with better procedural tools which are to be tested in practice soon.

[4] https://www.law.ox.ac.uk/business-law-blog/blog/2022/04/chinas-recent-regulation-variable-interest-entity-structures-has-led

3.4 Special Considerations for Listed Companies

Due to its tax-neutral position and a mature corporate legal regime derived from the common law system, since the 1990s, Cayman has long been a popular jurisdiction for the incorporation of companies intending to be listed on international stock exchanges. Many Chinese companies took advantage of it and used Cayman-registered entities to issue shares and bonds. A number of them achieved flotation on the international markets.

For those distressed listed companies with negative or stagnant growth, privatisation now has become a turnaround option to reduce the high maintenance and compliance costs of being publicly listed. In addition, due to geopolitics and regulatory policy changes, such as the introduction of the *Holding Foreign Companies Accountable Act* ("**HFCAA**") in the U.S., which imposes stringent supervision restrictions on U.S.-listed Chinese companies, privatisation seems to be inevitable for certain listed Chinese companies.

The abolishment of the "headcount test" for members' approval of the scheme of arrangement will facilitate the privatisation of Chinese overseas listed companies. For example, the "headcount" test has long been considered a "hurdle" for privatizations of HKSE-listed Cayman companies[5] and several high-profile privatisations were thwarted due to failure to satisfy this "headcount test". The Cayman-incorporated listed companies may now proceed with more certainty in the privatisation process after a comprehensive consideration of the time period, the transaction cost and the possible litigation risks.

In a nutshell, Cayman's new restructuring regime might have a profound impact on Chinese companies' cross-border restructuring. We shall continue to observe the new regime to be tested in practice in the coming future. Stay tuned.

[5] As of June 2021, 67% of the 2,190 companies listed on the Main Board of Hong Kong Stock Exchange (HKSE) are Cayman-registered companies.

If you would like to know more information about the subjects covered in this publication, please contact:

Yuhua Yang
+86 10 8519 2266
+44(0)20 3283 4337
yuhua.yang@llinkslaw.com

Amy Ren
+86 21 6043 3788
amy.ren@llinkslaw.com

Shawn Xu
+86 21 3135 8768
shawn.xu@llinkslaw.com

Rebecca Hume
https://gateleyplc.com/people/rebecca-hume/

SHANGHAI
19F, ONE LUJIAZUI
68 Yin Cheng Road Middle
Shanghai 200120 P.R.China
T: +86 21 3135 8666
F: +86 21 3135 8600

BEIJING
30F, Central Tower, China Overseas Plaza, 8 Guanghuadongli,
Chaoyang District
Beijing 100020 P.R.China
T: +86 10 5081 3888
F: +86 10 5081 3866

SHENZHEN
18F, China Resources Tower
2666 Keyuan South Road,
Nanshan District
Shenzhen 518063 P.R.China
T: +86 755 3391 7666
F: +86 755 3391 7668

HONG KONG
Room 3201, 32/F, Alexandra House
18 Chater Road
Central, Hong Kong
T: +852 2592 1978
F: +852 2868 0883

LONDON
1/F, 3 More London Riverside
London SE1 2RE
United Kingdom
T: +44 (0)20 3283 4337
D: +44 (0)20 3283 4323

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