IN THE COURT OF APPEAL OF THE CAYMAN ISLANDS

Civil Appeal No. 34 of 1998
Grand Court Cause No. 7 of 1998

BETWEEN:

ALLIED LEASING AND FINANCE CORPORATION

Appellant

- and -

BANCO ECONOMICO

Respondent

BEFORE: The Rt. Honourable Mr. Justice E. Zacca, President
The Rt. Honourable Mr. Justice P.T. Georges, J.A.
The Honourable Mr. Justice G. Collett, J.A.

John Martin Q.C., Thomas Lowe and Linda daCosta instructed by Myers & Alberga for the Appellant.
Robert Hildyard Q.C., Guy Locke and Sara Collins instructed by Walkers for the Respondent.
Ross R. McDonough instructed by Bruce Campbell & Company for the Liquidators.

November 22nd, 23rd, 24th, 25th, 26th, 29th and 30th 1999; May 5th 2000

JUDGMENT

GEORGES, J.A.

This is an appeal from a judgment of Graham J. in which he ordered that the appellant, Allied Leasing and Finance Corporation (the Company) be wound up subject to the provisions of the Companies Law (1995) Revision. The basis of the petition for the winding up was that the Company was substantially indebted to Banco Economico S. A. (the Bank) and was unable to

pay its debts. The Bank at the date of the filing of the petition was itself in liquidation. It was a large Brazilian Bank (the 7th largest in Brazil) and had been put into liquidation on the application of the Central Bank of Brazil in which was vested regulatory powers in relation to banks in that country.

The Company was incorporated on March 14, 1989 as an exempt company under the Companies Law. It appears undisputed that it was formed for a particular purpose. The Bank wished to own a plane to facilitate the travel of its personnel in Brazil. Brazilian entities could not lawfully purchase aircraft. The Company was formed to purchase an aircraft. The money to purchase was provided by the Bank. The Company leased the aircraft to Aratu Taxi Aereo S.A. (Aratu) - a firm owned by Angelo Calmon de Sa who was employed by the Bank as Superintendent - the equivalent of Chief Executive Officer. Aratu would lease the aircraft to the Bank and possibly to other companies. Sums received as rent would be deposited at the Bank and be credited towards the payment of the loan.

In 1992 the Bank's lease of its corporate headquarters in Bahia expired. The building was a modern, well appointed building on 11 floors. The Bank did not want to move. The Bank was unwilling to purchase the building directly. Allied Leasing purchased the building with a loan made available by Transworld Bank - a bank incorporated and effectively controlled by the Bank. The Company granted the Bank a lease of the Building. Subsequently, the Bank took over the loan originally granted by Transworld. Rental payments falling due under the lease were deposited at the Bank and credited to the servicing of the loan.

These facts established that the Company undertook no investments with entities other than the Bank. It was a central contention of the Company's case that those transactions were on the basis that the Bank made all the decisions relating to the risks of any investment. The Company was merely used to facilitate the transaction. Accordingly, losses would be borne by the Bank which could have no recourse against the Company but only against the asset in which the investment had been made. It was in the language of Mr. Azavedo, a former director of the Bank who opposed the winding up order -

"A vehicle to be used for specific transactions ..... a foreign company in a lightly regulated jurisdiction ... in a place without a tax regime..... It was a totally passive partner in transactions with Economico"

It seems also indisputable that the relationship between the Bank and the Company was always that of creditor and debtor and that the Company had no assets other than those acquired with loans from the Bank.

Mr. Azevedo states that until 1992 the nominee shareholder of the Company was a Panamanian nominee company incorporated in Panama. That company was operated by the Bank and its officers were Mr. Andres Neeser and Mr. Castellari, two employees of the Bank.

In July 1994 the shares of the Company were transferred to a company called White Lightning incorporated in the British Virgin Islands. White Lightning was wholly owned by a Mr. Cesar Mello who appears not to have been in any way connected with the Bank.

Mr. Azevedo, in his first affidavit of 18th February, 1998 in opposition to the petition, explains that the change of ownership was necessary because of additional investment activity being

undertaken by the Company in 1993-4 still in close relationship with the Bank. The records had to show that the Company was owned outright by an entity other than the Bank.

About that time Brazilian monetary regulations permitted non-residents of Brazil to hold accounts in Brazil and to make investments in Brazil from these accounts known as "Carta Circular" accounts (CC 5).

Non-residents could also invest in what were termed "ANNEX IV" Investments in Brazil. The investment could be made only through a Brazilian Institution registered under Brazilian law. Monies in a CC 5 account could be used to purchase investments.

The Company formed a wholly owned subsidiary to take advantage of the opportunities existing under these regulations. This subsidiary incorporated in the British Virgin Islands was known as Allied Investment Fund Ltd. (Investment Ltd.). The Bank on its part controlled a wholly owned Brazilian Institution - Economico S.A. Corretoras de Cambio e Valores Mobiliarios (the Institution). Investment Ltd and the Brazilian Institution agreed to establish a securities portfolio under a name which can briefly be referred to as "Cartiera". Cartiera would administer the portfolio. Among the terms of the agreement was one committing the Institution to -

"administer the ...Securities Portfolio which shall include the purchase and sale of securities, in accordance with the Contracting Party's instructions as provided by its Investment Manager."

The "Contracting Party" was Investment Ltd.

In effect, therefore, the Bank arranged for the formation of a non-resident Brazilian entity which would invest funds in Brazil through the Brazilian Institution controlled by the Bank. Mr. Azevedo explains that the non-resident Brazilian entity could not appear on the records to be owned by a person or company in the control of the Bank. The Central Bank may very well have ruled that the Company and its wholly owned subsidiary Investment Ltd. was not non-resident for the purposes of the Regulations. Hence the need to introduce White Lightning and Mr. Melo.

In paragraph 6.6 of his first affidavit Mr. Azevedo states -

"Since Allied Leasing depended on Economico it was not envisaged that the change in ownership would bring about any change in management or in the relationship between Allied Leasing and Economico."

There is no dispute as to the method used in carrying out the transactions envisaged in the agreements between the Company through its subsidiary Investment Fund and the Bank through its subsidiary, the Brazilian Institution. The usual link in the transaction was a branch of the Bank established in the Cayman Islands.

Whenever there was excess liquidity at the Bank's Cayman Branch, the Branch would seek confirmation from the Bank, normally the Sao Paulo Branch, that money could be advanced to the Company to be invested in Annex IV Securities or lodged in the Company's CC 5 account.

Once permission had been obtained, arrangements would be set in train to have the agreed amount converted from US dollars held in the Caymans Branch to Reais to be lodged to the credit of the Company in its CC 5 account in the Bank at Sao Paulo.

As security for the loan the Company would issue to the Cayman Branch a Unitary Participation Investment Certificate (UPIC). Each certificate represented a share in various Brazilian assets held by the Company and managed by the Brazilian Institution controlled by the Bank. A maturity date was fixed. The Company guaranteed that on that date the UPIC would be redeemed by payment of the sum borrowed plus interest due.

In each case, therefore, the transaction between the Company and the Bank was structured in the form of a debt owing by the Company to the Bank and usually evidenced by a UPIC. The Company did not enter into any investment transactions in Brazil save through the Bank and its subsidiaries.

The petition was a creditor's winding up petition. It was based on debts arising from four sources.

The first was the debt arising from the purchase of the aeroplane which was subsequently leased to Aratu which in turn chartered it to the Bank as needed - the clean advance demand.

The second was based on the purchase of the headquarters of the Bank which also was subsequently leased to the Bank - the secured advance.

The third was the overdraft arising from advances made to the CC 5 account, parts of which may have been placed in Annex IV investments.

The fourth was based on promissory notes originally issued by the Company which were discounted by the Bank and dishonoured when presented for payment.

The underlying defence to the claims in respect of the first, second and third debts is on an Investment Agreement. This bears the date 14 March, 1994 and is signed by Mr. Nisser on behalf of the Bank (Cayman Islands Branch) and Mr. Donelly on behalf of the Company. The original has not been tendered in evidence. In his third affidavit dated 3 July 1998 at paragraph 3 Mr. Donelly states that the "relationship between Allied and Economico was not based upon the written investment agreement...but was evidenced by it." [Emphasis in the original]

The transactions from which the claim known as the "demand clean advance" and "the secured advance" arose predated 14 March, 1994, but it has been urged that the structuring of the transactions conformed with the relationship described in the Investment Agreement. On the face of it, the language of the Investment Agreement relates to Annex IV transactions.

The nub of the argument was that the Bank would accept in satisfaction of loans made by the Bank to the Company, the face value of the investments purchased with such loans, whatever may be their realisable value in the market.

The relative clause in the Investment Agreement reads -

"If at any time as a result of failure of the investment transaction, or any act of government that ..... the non-repayment of INVESTMENTS, the BANK will accept any or all securities and/or other assets at its face value in partial or full settlement of the INVESTOR'S debt, provided those securities and/or other assets were acquired under the guidance of the BANK including those acquired prior to this Agreement."

The appellants contend that there has been raised a "bona fide dispute" as to whether the debts on which the petition was based were indeed due and consequently the petitioner did not have locus standi. The argument was that the judge had reached findings of facts on conflicting affidavit evidence. There had been no discovery and no exchange of statements. The offer of an opportunity to cross-examine witnesses on their affidavits had not been helpful since the material which could make effective cross-examination possible had not been available.

It was urged that the contents of the Company's affidavits, once provisionally accepted, established a bona fide dispute as to the indebtedness and that should be the end of the matter. At that stage the petition should have been denied leaving the Bank free to pursue a judgment for the sums claimed by the normal procedures with the usual procedural safeguards.

At the outset one issue should be made clear. The courts have constantly stressed that it is an abuse of process to use the procedure of a winding up petition to coerce a debtor into settling a disputed debt. This is as it should be. Once a petition is filed the debtor's business is placed under a cloud. Credit may well become unavailable and survival threatened. The circumstances of this case are completely different. The Company did no business with any other entity but the Bank. At the date of the filing of the petition it had done no business for 2

years. In no sense could the filing of the petition be described as an attempt at coercion. It was a predictable move to tidy up the affairs of the Company which had been formed in the first to facilitate the business of the Bank. Once the Bank had been put into liquidation there could be no more business to facilitate. In the final analysis, the issue was whether the liquidators of the Bank should be in charge of the liquidation of the Company or whether the shareholders now owning the Company on the record should carry out that task.

One of the earlier and much cited authorities on the issue of determining whether there was a bona fide dispute as to the existence of a debt on which a petition was based is Re Welsh Brick Industries Ltd L.A. [1946] 2 all E.R. 197.

On 18 February, 1946 the petitioner issued a writ in the King's Bench for a sum of money advanced to the Company. On 9 April, 1946 he presented a petition for winding up in respect of the same debt, alleging that the Company was unable to pay its debts. On 26 April, 1946, on a summons for judgment under RSC O. 14, the Registrar granted the Company unconditional leave to defend.

The petition came up for hearing before a county court judge who found on the evidence before him that the debt was owing and that the Company could not pay. He made the winding up order. The Company appealed, contending that the grant of unconditional leave to defend was conclusive evidence that there was a bona fide dispute and that winding up order proceedings were not appropriate.

In his judgment at p. 198, Lord Greene M.R. stated -

"I do not think that there is any difference between the words "*bona fide* disputed" and the words "disputed on some substantial ground". I cannot accept the proposition that, merely because unconditional leave to defend is given, that of itself must be taken as establishing that there is a *bona fide* dispute or that there is some substantial ground of defence. The fact that such an order is made is no doubt a matter which the winding-up court will take into consideration and to which the winding-up court will in due course pay respect, but I cannot regard it as in any way precluding a winding-up judge from going into the matter himself on the evidence before him and considering whether or not the dispute is a *bona fide* dispute, or, putting it in another way, whether or not there is some substantial ground for defending the action."

Inevitably "determining whether or not the dispute is bona fide" will involve some examination of the facts.

In Re Claybridge Shipping Co. S.A. [1977] BCLC 572, the company was a Panamanian company engaged in the business of chartering ships for the transport of corn and wheat from Australia to Egypt. The chartering operations were carried out in Piraeus, but the banking business was done at a branch of the United Bank Ltd in London.

The Bank filed a petition to wind up the company claiming that the company was in overdraft in the sum of $30 million. The company disputed the debt. It claimed that there had been unauthorised debits made on the sole signature of a Mr. Maniar. Originally the company had mandated the bank to permit such debits, Mr. Maniar being then the sole shareholder or that sole signature. Subsequently, the company claimed it had revoked this mandate and had required that payments be made only on the joint signatures of Mr. Maniar and a Mr. Kontozanis who had by then invested money in the company. There had never been a written notification of the change.

The company's account with the bank contained both debits and credits which were said to be unauthorised. The company claimed the benefit of the unauthorised credits but asserted that the unauthorised debits should be removed.

The trial judge rejected the petition and ordered that it be removed from the record. The bank appealed.

Oliver L.J. set out his view of the law which clearly indicated that the Companies Court should be able to examine the facts to determine whether or not there was a substantial dispute. He stated at p. 578 -

"On an application like this the court necessarily has to take a view whether, on the evidence, there really is substance in the dispute which is raised. In the instant case the argument appears to me to be such a tenuous one that I for my part do not feel that I could identify it as one which appears to me, on the present evidence, to be one either of bona fides or of such substantiability as to warrant the petition being struck out.

I do not wish in the least to cast doubt on the practice of the Companies Court - which is well established of staying a petition in circumstances where there is a bona fide and substantial dispute as to the existence of a debt and leaving it to the parties to fight the matter out between them in an action. But that is, at highest, a rule of practice and it must, I think, give way to circumstances which make it desirable that the petition should proceed, although it may be that that would apply only in very exceptional circumstances."

The trial judge did take guidance from this statement of the law. There were exceptional circumstances in this case. The Company was formed as a wholly owned subsidiary of the Bank to facilitate transactions which could only be lawfully carried out under the laws of Brazil if effected with the intervention of an entity with a legal persona separate from that of the Bank.

Essentially, a finding as to whether or not there was a substantial dispute regarding the Company's indebtedness to the Bank depended on an evaluation of the Investment Agreement.

Although there is a dispute as to the date when it was signed, there is no doubt that this was long after the transaction which led to the incorporation of the company: namely, the purchase of the aircraft. It has been urged that the structuring of the transaction indicated that even at that stage the Company and the Bank operated on the basis of no risk no reward. This can only be speculation.

As has been noted, the Company purchased the aircraft with a loan from the Bank. The Company leased the aircraft to Aratu Taxi Aereo SA, a company owned by a senior employee of the Bank. Aratu in turn chartered the aircraft to the Bank for its use. The charter payments were directly applied to the payment of the loan account. As Mr. Donelly explains it in paragraph 3.3 of his first affidavit -

"In fact the lease payments would never physically leave Economico being applied immediately in discharge of Allied Leasing's [the Company's] borrowings."

In a situation in which all the participants were effectively controlled by the Bank, considerations of ultimate risk and reward would hardly have been of real concern. The objective was providing an aircraft for use by the Bank. The legal structures put in place were designed to achieve that object.

The situation with regard to the "secured loan advance" was clearly analogous. As has been noted, the Bank advanced to the Company the money with which to purchase the building

which housed the Bank's headquarters. Thereafter, the Company leased the building to the Bank. Rentals due under the lease were paid towards satisfaction of the money advanced for the purchase. The structure in this case was even simpler since there was no need for an intermediate company such as Aratu Aero Taxi. The lease was directly from the Company to the Bank. Since the Bank had procured the incorporation of the Company as a wholly owned subsidiary, the negotiators on both sides were in economic reality the same though the legal entities were separate. Issues of ultimate risk and reward would not have called for consideration.

The transactions were, however, structured in terms of the advancing of a loan and the making of provision for its repayment. So long as the entities remained under the control of the Bank no difficulties would have arisen. The complication arose from the transfer of the shares of Transworld which owned the Company to White Lightning, a British Virgin Island Company owned by a Mr. Melo.

The reality of that situation is acknowledged by Mr. Azevedo in para 6.4 of his affidavit of February 1998. He states -

"Until 1994 no one (least of all myself) had considered the question of the beneficial ownership of Allied because it was in practical terms unnecessary to do so."

As has been emphasised above, until then there was no need to consider risk and reward. The affidavit continues -

"It was only when Allied's activities were expanded that real ownership had to be addressed. Because Allied then needed to have separate ownership to be entitled to operate as an Annex IV investor the shares of Allied Leasing had to be owned outright by somebody else ....."

He then pointed out that neither Aratu nor Mr. Calmon de Sa wanted to own the Company legally or beneficially. He continued -

"6.5 Mr. Gaius Cesar Melo, a Brazilian investor, was willing to take the shares outright. In mid-1994 the share capital of Allied Leasing was sold outright to White Lightning Corpn. Allied Leasing is still a subsidiary of White Lightning Corpn. White Lightning is in turn owned by Mr Melo....

6.6 Since Allied Leasing depended on Economico it was not envisaged that the change in ownership would bring about any change in management or in the relationship between Allied Leasing and Economico. Mr. Melo was making a speculative investment. At the time the Allied Companies had not traded for profit and had no real value."

In 1994 Mr. Azevedo was director of the Bank and until the intervention he was the Chief Financial and International officer of the whole of the Bank's banking operation.

Since Mr. Melo's acquisition of the shares would not bring about any change in management or in the relationship between the Bank and the Company, it would remain merely a matter of record unknown to anyone but those effecting it.

The Investment Agreement is dated 14 March, 1994 but there are conflicting accounts in the affidavits of the date of the signing. The Judge accepted the date stated in the affidavit of Mr. Neeser, the manager of the Cayman Branch of the Bank. He was positive that he signed it on a date after the intervention in 1995.

It is urged that he should not have made such a finding without having had cross-examination of the deponents. His analysis of the factual background supports his finding.

In any event the language of the Investment Agreement is not decisive. It is not reconcilable with documents, the authenticity of which is unchallenged. It cannot be interpreted to support the contentions of no risk, no reward on which basis the substantial dispute raised by the Company allegedly rests.

The terms "The Certificates" and "The Investments" are defined as follows -

"The CERTIFICATES

The CERTIFICATES will convey to the BANK the right to claim on the INVESTOR for repayment of the amount invested plus stated rate of return, also, the CERTIFICATES shall evidence the INVESTOR's obligation to repay to the BANK, on the maturity date of each CERTIFICATE, the face amount of the CERTIFICATE plus the stated amount of return.

The INVESTMENTS

The INVESTMENTS, object of the issuance of the CERTIFICATES, will be represented by Brazilian securities and/or other assets, acquired by the BANK or its related parties in Brazil, through several mechanisms that allows for foreign investment in Brazilian securities and/or other assets, including but not limited to ANNEX IV and CC-5 ACCOUNTS and its tenure should coincide with the tenure of the CERTIFICATES."

The definitions appear to prescribe that a certificate should match a particular investment as the underlined words in the definition of "The Certificates" indicate.

The Certificates issued by the Company to the Bank contain language which is not consistent with that.

"THIS CERTIFICATE CONVEYS TO THE SHAREHOLDER A FULL AND UNENCUMBERED PRO RATA OWNERSHIP INTEREST IN THE BRAZILIAN INVESTMENT PORTFOLIO OF ALLIED LEASING AND FINANCE CORPORATION.

ALLIED LEASING AND FINANCE CORPORATION GUARANTEES THAT ON THE MATURITY DATE THIS CERTIFICATE SHALL BE REDEEMED AND CANCELLED BY PAYMENT TO THE SHAREHOLDER OF THE PAR VALUE PLUS U.S. $2,224,444.44 FOR A TOTAL PAYMENT OF U.S. $22,224,444.44 WHICH SHALL REPRESENT A 22.00% P.A. GUARANTEED RETURN."

The Certificate conveys a pro rata share in an investment portfolio, not specifically identified with any particular security. The provision that the tenure of any investment should coincide with the tenure of any certificate could not be fulfilled.

The judge could accordingly quite properly hold that the Investment Agreement did not raise any substantial dispute which could justify an adjournment of the petition for winding up pending its resolution.

In relation to the claim under the discounted promissory notes the judge correctly found that the transactions which led to their being issued could not in any way be related to the Investment Agreement. They were completely separate.

A promissory note is a negotiable instrument freely transferable. Although the paying agent on this note was Transworld, liability under the note was the liability of the Company. There was no defence to that liability. In paragraph 25.1 of his affidavit of July 3rd, 1998 Mr. Azevedo appears to raise as a defence the following –

"Under the terms of the note payment was to be made by the paying agent. The paying agent obviously had a right to be credited in advance of such payment being made. It had a right to transfer the responsibilities of paying agent to another party."

Such a defence can raise no substantial dispute meriting separate resolution.

The issue of the debt due on the overdraft was entirely a matter of the examination of the account. The trial judge examined a reconciliation prepared by the attorneys for the Bank and was satisfied as to the correctness of the sum claimed. Before us Mr. Hildyard dealt with what he described as the missing $20 million - an issue raised by the Company on the accounts. I am satisfied with his explanation that it is accounted for by repayment of a fixed deposit.

Two issues remain for short comment - the issue of the burden of proof and the decisions and remarks made by Smellie J (as he then was) on the interlocutory applications made before him (referred to in the judgment as "the Smellie guidelines").

Graham J correctly held that the burden rested on the Company to show that the debt was disputed on substantial grounds. Of course this burden would arise only after the petitioner has established a prima facie case that the debts on which the petition was based were due and owing. In this case the evidence led by the Bank established such a case.

There are two rulings by Smellie C.J. which are of particular relevance. In the first he refused an application for an order for the cross-examination of the petitioner, Mr. Flavio Cunha. He

held that once allegations of fraud contained in an earlier affidavit were not pressed, the four aspects of the indebtedness on which the petition was based would be primarily matters of accounting and contract and there would be no basis for ordering the cross- examination of Mr. Cunha.

The learned Chief Justice quoted and stressed the advice given by Lord Templeman in delivering the opinion of the Privy Council in Tay Bok Choon v Tahansan Sdn Bhd [1987] 1 W L R at p. 418.

In another ruling dated 2 July, 1998 Smellie CJ. stated that he had concluded that in the circumstances of the case it would be inappropriate to compel either side to have its witnesses submit to cross-examination. He then added -

"The observation I would wish to make is that given the massive indebtedness here alleged, the prima facie proof of that indebtedness being in the records recovered by the duly appointed liquidator, it would be a remarkable outcome indeed in this already remarkable case, that the petition could be staved off by the evidence of witnesses - untested by cross-examination - that there ought to be in existence evidence of the redemption of that indebtedness which they have not yet seen. This, I also observe, would be all the more unlikely because that evidence has neither been the subject of an application for, nor an order for, discovery. No such order has been sought by the Company although its attorneys have written seeking discovery."

Clearly Graham J. accepted the approach of Smellie CJ in the evaluation of the evidence as set out in the affidavits filed by the Company in response to the petition. This he was entitled to do.

In the result the appeal against the order that the Company be wound up and that joint liquidators be appointed is dismissed. The issue of costs, both of this appeal and of the proceedings before Graham, J., is reserved for further argument.

Zacca, P.

I agree.

Collett, J.A.

I agree.