

# British Virgin Islands – Directors’ exposure in a context of financial distress

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**The liquidity crisis of the last 18 months continues to have a telling impact on corporates in several sectors the world over, and refinancings and waiver requests are on the increase. As the financial crisis becomes even more embedded and as corporates run out of cash, they will no doubt in due course be looking for new loan capital or seeking to raise fresh equity. Some of this is already happening. By and large banks remain risk averse as do shareholders so it is clear that some will be fortunate and receive a life line whilst others will not. Financial distress is therefore unfortunately a given for several corporates and directors need to be cognisant of their potential exposure.**

So when is a BVI company insolvent? As a matter of British Virgin Islands (“BVI”) law, a company is insolvent if one of the following can be established:

- the company fails to comply with statutory demand which has not been set aside;
- execution or other process issued on a judgment is returned wholly or partly unsatisfied;
- the company’s liabilities exceeds its assets; or
- the company is unable to pay its debts as they fall due.

If any of these scenarios exist, directors of BVI companies need to be aware that their duties will have changed.

## Directors’ duties

Whilst the company is a going concern and solvent, directors’ duties at common law and under statute are owed to the shareholders as a whole. In very rare instances duties may be owed to individual shareholders. However, when the company becomes insolvent or is of doubtful solvency those duties shift to the company’s creditors. Thus for example, parent/subsidiary situations where directors are the same would have to be carefully reviewed and considered. Certain statutory provisions in BVI company law permit the directors of the subsidiary in specific circumstances to act in the best interest of the parent. Such provisions whilst completely valid are of course at odds with the common law position of directors’ duties and it is doubtful whether such statutory provisions are meant to operate when the company is insolvent. It is submitted that the better view out of an abundance of caution is that the directors’ duties to creditors take centre stage.

In an insolvency context, breach of duty may result from entry into voidable transactions and the typical ones are unfair preferences and undervalue transactions.

The test of an unfair preference is “what is the “effect” of the transaction?” If the effect is to place one creditor in a better position in the liquidation of the company than if the transaction had not been entered into then the transaction will be an unfair preference. Because directors must have determined whether to enter into a transaction, their actions may very well be called into question.

Likewise, an undervalue transaction is an insolvency transaction entered during the vulnerability period and is either (i) a gift by the company; (ii) a transaction in which no consideration is received by the company; or (iii) a transaction in which the value of the consideration received by the company is significantly less than that provided by the company. Once again the directors must have determined that the company should enter into that transaction and their actions scrutinised.

As a result of a breach of duty the Court may order contributions by the directors.

In terms of determining whether a transaction is an undervalue transaction or an unfair preference there are various hurdles to be crossed. Was the transaction within the vulnerability period? If it was entered into within six months prior to the onset of insolvency (or within two years if with a “connected” person) then the answer is “Yes”. It should be noted that the term “connected person” is given a very wide meaning.

Secondly, was the transaction an “insolvency transaction”? If it was entered into when the company was insolvent or the transaction causes the company to become insolvent, for these purposes this essentially means cash flow insolvent, then it is an insolvency transaction.

Thirdly, when exactly does the “onset of insolvency” commence? The short answer is it depends. It may be the date when the application is

filed for the appointment of a liquidator (where the company goes into liquidation). Alternatively, it may be the date of appointment of the liquidator when appointed by members or finally the date when the application for an administration order is filed if liquidation immediately follows administration.

### Insolvent trading

Known as "wrongful trading" in the UK, a director may also be required to contribute to the company's assets where he knew or should have known that before the commencement of liquidation there was no reasonable prospect of avoiding insolvent liquidation and he failed to take every step reasonably available to minimise loss to the company's creditors. A potential defence on the part of the director is therefore that he took every step open to him.

A court will consider what steps the directors took and in this regard will look at a combination of the objective and the subjective. What is his skill and knowledge and what can reasonably be expected from a person carrying out the same functions? He will be judged by the objective standard if his skill is below the reasonably expected standard. On the other hand, if his skill is above the reasonably expected standard then his own higher standard will apply.

The Court will take into account the nature and size of the company in applying these tests and a failure to meet the test might result in the director being liable to contribute to the company's assets in liquidation or may be grounds for a disqualification order.

In relation to insolvent trading, it is not entirely clear what is the limitation period because the

Insolvency Act 2003 (BVI) is silent but based on an English decision in a similar context it is felt that it is six years and runs from when the company goes into insolvent liquidation.

### Conclusion

A director of a BVI company should be alive to his potential exposure where the company is in financial distress and should note that resignation is not necessarily a solution. Are there steps that directors can helpfully take?

- Be alert to the company's financial position.
- Carefully consider transactions for preference or undervalue risks.
- Have realistic expectations about the company's prospects.
- Keep careful records.
- Hold board meetings regularly.
- Check D&O Insurance. What does it cover?
- Take legal advice as early on as is possible.

None of the foregoing is an insurance policy against liability but taken together may just be enough to make a difference.

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