International Corporate Rescue

Directors’ duties to consider the interests of creditors when nearing insolvency

Synopsis

In the recent decision of BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112 the English Court of Appeal provided welcome guidance on when the duty to take account of creditors’ interests arises. This is the first time the English courts have expressly considered the precise point in time before insolvency at which the duty arises. The issue has not yet arisen for determination in the Cayman Islands, although it is likely that the Cayman courts would follow this decision. The duty of directors to consider creditors’ interests is owed to the company, not to creditors. The duty to act in the interests of creditors might include considering whether the company should be placed into liquidation – the Cayman decision of Skandinaviska Enskilda Banken AB v Conway & Another (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Ltd) is a prime example of the consequences of not doing so – or whether a company has assets of sufficient value to declare a dividend and still be able to meet its liabilities.

Courts of the Cayman Islands, like courts in other common law jurisdictions, recognise that where a company is insolvent or doubtfully solvent, the interests of creditors intrude and directors will have a duty to have regard to those interests. In the case of a solvent company, the interests of the company are generally identified with the interests of shareholders; whereas where a company is insolvent, the interests of creditors intrude. The rationale is that because of the company’s insolvency, its assets are in a practical sense the assets of the creditors, pending liquidation or return to solvency.

But what about when the company is on the verge of insolvency, or is likely to become insolvent, or where there is a real as opposed to remote risk that the company might become insolvent? Will those situations trigger the duty? When does the duty to take accounts of creditors’ interest actually arise? The English Court of Appeal recently considered these issues in *BTI 2014 LLC v Sequana SA & Ors* [2019] 2 All ER 784. The decision will undoubtedly be of interest and almost certainly followed by the courts of the Cayman Islands and other common law jurisdictions.

The Grand Court of the Cayman Islands recognised the duty to take account of creditors’ interests when nearing insolvency in the decision of *Prospect Properties Limited (in liquidation) v McNeill & Anor* [1990-91 CILR 171]. Harre J endorsed statements of principle from earlier decisions of the English Court of Appeal and confirmed that directors need to consider creditors’ interests as part of their duty to act in the best interests of the company itself where the company is doubtfully solvent (*Prospect Properties (supra)* at 203):

- The English Court of Appeal in *West Mercia Safetywear Ltd v Doss* [1988] BCLC 250 cited with approval the following statement of principle of Street CJ in *Kinsela v Russell Pty Ltd (in liq)* (1986) 4 NSWLR 722:

  “In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise … But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets.”

- The English Court of Appeal in *Brady v Brady* [*1988*] BCLC at 40 said:

  “[I]n a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very much. Conversely, where there company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone.”

It was later described by the Grand Court as 'settled law in the Cayman Islands' that when a company is 'nearing insolvency or doubtfully solvent' directors must keep assets 'inviolate for creditors' and they will be in breach of their fiduciary duties if they do not (*Hutchinson Limited & Ors v Cititrust (Cayman) Limited & Ors* [1998] CIRL 43 at p 61).

This duty is recognised in legislation in England. Section 172(3) of the UK Companies Act 2006 provides that a director's duty to promote the success of the company will 'in certain circumstances' require directors 'to consider or act in the interests of creditors.' While there is no express recognition of the duty in Cayman Islands' legislation (and in fact directors' duties are not codified in Cayman Islands' legislation at all), legislation does recognise that a company's solvency status will impact on whether liquidators are to act in the interests of contributors or creditors. For example, in a solvent liquidation it is the duty of an official liquidator to report to contributories; whereas liquidators are to report to creditors and there is no continuing duty to report to contributories where the company is regarded as insolvent (Order 10, rule 1 of the Companies Winding Up Rules (2018 Revision)).

The English Court of Appeal in *BTI v Sequana (supra)* considered when and in what circumstances the duty to have regard to the interests of creditors arises. David Richards LJ (with whom Longmore and Henderson LJJ agreed) noted that there is no English decision which is clearly based on the proposition that the duty is triggered by anything short of actual insolvency, yet many judges seem to have assumed that 'something less than actual insolvency will trigger the duty' (at [195]). However, in previous cases the companies were in fact insolvent and so the issue of the timing of the precise trigger had not been the subject of extensive argument (at [195]).

In *BTI v Sequana (supra)* dividends had been paid at a time where the company had ceased to trade and had one material liability. Through a complex series of corporate transactions, the company had contingent indemnity liabilities in respect of clean-up costs and damages claims resulting from river pollution in the United States. The company's assets consisted of an investment contract, historic insurance contracts, and inter-company debt. The directors estimated the company's likely exposure under the contingent liabilities and concluded that the company had sufficient reserves to declare a dividend. The directors made provision against the contingent liabilities and declared two dividends in 2008 and 2009 totalling approximately €580 million paid to its parent company to off-set inter-company debt. The company's creditors alleged the provision made by directors was manifestly inadequate. The company brought claims against the directors for breach of the duty to have regard to the interests of creditors, and that the payments of dividend were transactions at an undervalue for the purposes of defrauding creditors.

In the first instance judgment, described by the English Court of Appeal as 'comprehensive and impressive' (BTI v Sequana (supra) at [4]), Rose J held that the creditors' interests duty had not arisen at the time of the directors' decision to pay the dividends (BTI 2014 LLC v Sequana SA [2017] 1 BCLC 453). The company's balance sheet showed no deficit of liabilities over assets, there were no unpaid creditors knocking at the company's door, and it was not in a downward spiral accumulating trading losses with no income. Rose J said:

> "It cannot be right that whenever a company has on its balance sheet a provision in respect of a long term liability which might turn out to be larger than the provision made, the creditors' interests duty applies for the whole period during which there is a risk that there will be insufficient assets to meet that liability. That would result in directors having to take account of creditors' rather than shareholders' interests when running a business over an extended period. This would be a significant inroad into the normal application of directors' duties." (*BTI v Sequana (supra)* Rose J at [497]).

On appeal (and upholding the decision of Rose J), David Richards LJ (with whom the other judges concurred) carried out a detailed analysis of prior authorities. In the first decision to mention a duty to have regard to creditors' interests, Horsley & Weight Ltd [1982] 3 All ER 1045, the English Court of Appeal favoured a test of whether at the time of payment in question the directors "should have appreciated" or "ought to have known" that it was likely to cause loss to creditors or threatened the continued existence of the company. The New Zealand Court of Appeal in Nicholson v Permakraft (NZ) Ltd (in liq) [1985] 1 NZLR 242 determined that creditors are entitled to consideration where the company is "insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency" (at 249-250pp.). There were also authorities from Australia which suggested that the trigger for the duty is that the company faces or as a result of the proposed transaction would face "a real as opposed to a remote risk of insolvency" (for example: Grove v Flavel (1986) 43 SASR 410; Kalls Enterprises Pty Ltd v Baloglow [2007] NSWCA 191). David Richards LJ found that it was clear that prior authorities contemplated that something short of actual insolvency would trigger the duty. The authorities suggested four possible answers to the question of when the duty is triggered each of which meant something slightly different (at [213]):

1. when the company is actually insolvent, either on a cash-flow or balance sheet basis;
2. when the company is on the verge of insolvency or nearing or approaching insolvency;
3. when the company is or is likely to become insolvent (i.e. it is of dubious solvency); or
4. when there is a real as opposed to remote risk of insolvency.

The judge noted that he had already found that something short of actual insolvency would trigger the duty, so that the first formulation did not completely encapsulate the test.

The second formulation was too uncertain and could arguably lead to inconsistent results – the precise moment at which a company is insolvent can be difficult to pinpoint. Insolvency might happen suddenly or gradually.
The formulation in the second category suggests a temporal test which then suggests insolvency will follow shortly thereafter. It may not capture a situation where insolvency happens gradually but a duty should nevertheless arise because insolvency is likely to occur.
The fourth possible formulation would not be appropriate. In the Australian authorities, which had suggested that this lower standard might trigger the duty, the issue had either not directly arisen for consideration, or the companies were found to actually be, insolvent on the facts. It would amount to a development of the common law which was not justified.

The judge preferred the third possible expression. He found that it accurately captures the test for the trigger of the duty. The duty arises when directors know or should know that the company is or is likely to become insolvent. Likely means “probable” not some lower test (at [220]). This issue has not been expressly considered by the Cayman courts, although it is likely that it would follow the approach in England.

The English Court of Appeal agreed with Rose J that the duty had not been triggered, thus leaving open for another day what happens once the duty is triggered – ie whether creditors’ interests are paramount or are to be considered without being decisive. However, David Richards LJ expressed a preliminary view that when directors know or should know that the company is currently insolvent it is hard to see how creditors’ interests could be anything other than paramount (BTI v Sequana (supra) at [222]).

Some early decisions had innocuously and possibly inadvertently suggested that directors owe the duty to creditors (see for example Winkworth v Edward Baron Dev. Co. Ltd [1987] 1 All ER 114 at 118). It has since been clarified that directors do not owe a direct fiduciary duty towards an individual creditor, rather, a director of an insolvent company acts in breach of his duty to the company by causing assets of the company to be transferred in disregard of the interests of creditors (Yukong Line Ltd v Rendsburg Investments [1998] 2 BLCL 485 (at page 503)). Creditors therefore do not have a direct cause of action against the directors or against the company for not considering its interests. It is for the company itself, usually through liquidators, to bring an action against the directors for breach of duty.

Where the duty arises, directors must have regard to the interests of the general body of creditors, not just one particular creditor or a section of creditors (Re Pantone 485 Ltd [2002] 1 BCLC 266). The duty arises in respect of current or likely continuing trade creditors. Courts have expressed doubt as to whether it would be possible to make out a duty to future new creditors (Cooke J in Nicholson v Permakraft (supra); cited by the English Court of Appeal in BTI v Sequana (supra) at [147]).

The duty to act in the interests of creditors might include considering whether the company should be placed into liquidation, whether particular transactions might amount to dispositions at an undervalue (in addition to action for a contravention of section 146 of the Companies Law, directors could theoretically also be liable for having failed to take into account interest of creditors when they should have), or when considering payment of a dividend (in particular whether the company has assets of sufficient value to declare a dividend and still be able to meet its liabilities).
An example of this issue at play is the Cayman Islands’ case of Skandinaviska Enskilda Banken AB v Conway & Another (as Joint Official Liquidators of Weavering Macro Fixed Income Fund Ltd). The company was the subject of a significant fraud perpetrated by Magnus Peterson, the principal of the investment manager to the company. He had been fraudulently inflating the net asset value of the company by entering into interest rate swaps which he knew to be worthless. He was later sentenced to 13 years’ imprisonment for offences including making a false instrument, furnishing false information, and carrying on business with intent to defraud creditors. The swaps gave the impression of sustained growth when in reality the company was suffering large losses from on-exchange trading in futures and options. The fraud was not discovered by the directors until March 2009 by which time redemption requests of over US$220 million had been received. The company was unable to pay these in full. The company was placed into liquidation on 11 March 2009.

It was found that if the directors had properly read the quarterly reports detailing the company’s assets and transactions, they would have realised that the company was insolvent and placed the company into liquidation much sooner, and redemption payments might have been US$111m lower. The Grand Court found that the directors were wilful in their neglect of their duties due to their failure to read the reports or to regularly hold meetings. The Court of Appeal upheld the finding that the directors had breached their supervisory duties (but did not agree that their failures were deliberate). The issue was not pursued on appeal to the Privy Council.

The duty to act in the interests of creditors is important not only for directors, who must ensure that they recognise when the duty to act in the best interests of the company has shifted from interests of contributories to interests of creditors, but also for a liquidator when investigating the affairs of an insolvent company and determining whether any action should be taken against former directors. However, directors should take comfort from the fact that the decision does not represent a significant shift in the extent of directors' duties. On 31 July 2019 the UK Supreme Court granted permission to appeal the Court of Appeal's decision of BTI v Sequana. Further guidance on the issue can therefore be expected in the near future.

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