HARNEYS

Creditors' interest duty: What to do and when to do it

It has long been established that company directors come under a duty to take creditors' interests into consideration when their company is in financial difficulty or enters what is commonly referred to as the "zone of insolvency". The recognition of this duty arose as early as 1976 in the Australian case of *Walker v Wimborne* and was subsequently adopted by a number of common law jurisdictions throughout the 1980s. The duty has been recognized in the Cayman Islands since at least Justice Harre's 1990 decision in *Prospect Properties Limited (in Liquidation) and McNeill and Bodden* and now forms a central part of the Cayman jurisprudence on directors' duties.

The rationale behind the rule is clear. When a company is insolvent, its assets are effectively the creditors' assets or, to put it differently, it is the creditors' money at stake. Lord Neuberger, adopting Chief Justice Street's famous dicta in the Australian case of *Kinsela v Russell Kinsela,* agreed with the view that:

"It is in a practical sense [the creditors'] assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors…"

Unfortunately, and despite the fact that the duty is now trite law, its application is far less certain and continues to give rise to a number of difficulties in practice; not least of which is determining when the duty actually arises. A host of different formulae such as "doubtfully solvent", "on the verge of insolvency", "in a precarious financial position", "the zone of insolvency" and many others have been used to describe when the duty is triggered. However, the various iterations have done little to help directors of Cayman (and other common law) companies know when their focus should shift from members to creditors.

BTI 2014 LLC v Sequana SA and ors

Helpfully, the English Court of Appeal attempted to remedy this issue in its February 2019 decision in *BTI 2014 v Sequana SA and ors [2019] EWCA Civ 112.*

The facts of *BTI*, so far as material, are that the claim cantered on an allegation that the directors of Sequana's subsidiary company breached their duty to creditors by paying a €585million dividend to Sequana by way of set-off when the company was subject to a significant contingent liability, which, if it materialized, may (or may not) have made the subsidiary insolvent.

In giving the judgment of the Court, Lord Justice Richards conducted an extensive review of the previous authorities and rejected the appellant's argument that the duty was triggered when there was a "real, as opposed to remote, risk of insolvency". Rather, he preferred the view that the duty only arises "when directors know or should know that the company is or is likely to become insolvent" and that "likely means probable, not some lower test"; noting that a real risk was a significantly lower threshold.

The decision is to be welcomed not only for the clarity it provides, but also as it sets the threshold at a business-conducive level. Were the threshold to have been set at the lower "real risk" test, there would have been a genuine concern that directors would be unduly cautious in situations of financial tension and perhaps over-eager to place companies into liquidation (or similar insolvency processes). However, Cayman directors can now take comfort that they need not overly burden themselves with creditors' interests until it becomes probable that insolvency will occur. It is worth remembering that creditors have other avenues by which they can protect themselves (such as the taking of security or guarantees, or initiating insolvency processes in their own name).

Returning to the issue of clarity, it may be somewhat optimistic to think the BTI decision has resolved all practical uncertainty. There will no doubt still be significant room for dispute as to when insolvency is probable; not least because it is not always clear when a company is actually insolvent. Nonetheless, directors should have a much better understanding of when the duty will arise than they did before.

Complying with the creditors' interest duty

Knowing when the duty arises is only part of the problem. The question still remains as to what the duty actually requires. This is by no means a straight-forward question, as was recognized by the Court of Appeal in BTI when it all but declined to form a conclusive view on this complex issue. Richards LJ put it as follows:

"…an important issue is whether, once the creditors' interest duty is engaged, their interests are paramount or to be considered without being decisive. This is not straightforward, and there has been a good deal of discussion about it in some of the cases and in the academic literature. It is not an issue that arises on the facts of this case and, in my view, it should be addressed on the facts of cases where it must be decided. I therefore express no view on it, save to say that where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors' interests could be anything but paramount."

The paramountcy of creditors' interests has been recognized in a number of other cases (see for example *Colin Gwyer & Associates v London Wharf (Limehouse)*. This position is fairly uncontroversial in situations where it is clear the company is insolvent and there will be no return to members. However, the position is far less certain in situations of doubtful solvency where there is potential for members to achieve a return. In such a situation should directors simply ignore members' interests or can they justifiably take a course of action, for example continuing to trade, that increases the risk to creditors but may lead to a potential return for members?

The courts are not oblivious to the diffi-culties directors face in these situations and have allowed a significant degree of leeway. In the law relating to unlawful trading for example, directors have been permitted to cause the company to continue trading while insolvent on numerous occasions, so long as the directors actively and bona fide considered whether to do so was in the best interests of the company and its creditors, even if it subsequently turned out to be a bad decision (see for example *Facia Footwear*).

The critical point is that directors do in fact take creditors' interests into consid-eration when making a decision. Once it has been established that the directors did actually consider creditor' interests, the test as to whether a breach of duty has occurred is subjective. The courts will ask "whether the director honestly believed that his act or omission was in the interests of the [creditors]".

It must be noted that the more egregious the decision, the more difficult it will be to establish that directors honestly believed it to be in the interests of the company. It must also be noted that, although a decision taken in good faith as to what is in the best interests of creditors is unlikely to breach the fiduciary duty to act in creditors' best interests, it may still fall foul of other duties, such as the duty to exercise the reasonable skill and care expected of a competent director.

Secured creditors

Another important question for directors to consider is to whom the duty actually applies. It is clear that the duty extends to unsecured creditors, but what is the situation in regards to fully secured creditors? After all, their interests are protected by their security.

The Royal Court of Guernsey certainly considered this a relevant factor in *Carlyle Capital Corporation v Conway and ors*:

"Secured creditors…are not at the same risk of unsecured creditors. They have first call on their security whatever risks or actions the company takes and they have a degree of control through whatever powers of realization their security confers on them… it means that their interests are fully protected by their security as long as it is adequate… and the secured creditors' interests therefore do not require the protection of being recognised in the same way as unsecured creditors."

Claims for breach of the duty

The law regarding whether creditors have direct standing to bring claims for breach of this duty is still developing and is by no means established. As a result, it is most commonly the case that claims are brought by liquidators. If this does happen, directors' best lines of defence tend to be either that the duty did not arise because insolvency was not probable, or there was no breach of the duty as the directors genuinely believed the action in question to be in the interests of creditors, even if the end result was to cause greater losses (although this may not be sufficient to defeat a claim based on a breach of the duty of skill and care).

Key takeaways

The key takeaways are:

- Directors need not overly burden themselves with the interests of creditors until it is probable that their company will become insolvent. The mere risk of insolvency is not sufficient to trigger the duty.
- Once the duty does arise, directors can protect themselves from claims for breach by ensuring that they do in fact consider creditor interests, and would be well-advised to record their considerations (such as by way of board minutes).
- In any event, the best protection directors can afford themselves (outside of exculpatory clauses and maintaining adequate professional insurance) is to seek legal advice as soon as it becomes apparent the duty may be triggered, and to record the fact that they have done so and have acted in accordance with the advice received.

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