Legal Guide

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Director duties in difficult times – practical advice for directors of a British Virgin Islands company facing financial trouble

It is critically important that directors of BVI companies understand their obligations under BVI law where a company is in financial difficulty and the measures they can take to mitigate related risks. History has shown that the companies that make painful decisions decisively on the basis of expert advice sooner rather than later tend to have a greater range of options and a better chance at recovery when facing financial trouble.

Key points

- A BVI company may be insolvent on a cash flow or balance sheet basis.
- Directors of an insolvent BVI company owe their duties to maximise value for the creditors, rather than the company.
- Insolvent trading concerns arise if a BVI company continues trading despite having no reasonable prospect of avoiding liquidation.
- In some circumstances, directors could face personal liability.
- There are sensible precautions and mitigating measures directors can take to help protect themselves against future claims by creditors or liquidators.
- There are a range of insolvency and restructuring tools under BVI law, but there is no "debtor in possession" procedure under BVI law equivalent to Chapter 11 in the US and no equivalent to the administration process under UK law.

Insolvency under BVI law

A BVI company is considered insolvent if it:

1. Is unable to pay its debts as they fall due (***cash flow insolvency***)
2. If the value of its liabilities exceeds the values of its assets (***balance sheet insolvency***)
3. Fails to comply with a valid statutory demand, or a judgement or order of a BVI court against the company is returned wholly or partly unsatisfied (***technical*** or ***deemed insolvency***)

Cash flow insolvency is more likely to be a problem in times of economic recession, as companies may have a relatively healthy balance sheet but see a decrease in cash coming in, whilst their obligations to their creditors remain unchanged.

Director duties and misfeasance

Directors of a BVI company owe various statutory and fiduciary duties to the company (summarised more fully here). The BVI Court has broad powers to order a director (or other officer) of a company in liquidation to pay compensation to the company where the director “has been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company”.

As confirmed by the UK Supreme Court judgment *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, when a company is financially distressed the directors' fiduciary duty to the company to act in its interests is modified to include a duty to act in the interests of creditors as a whole. The duty is, in effect, a sliding scale. At one end of the scale, the Supreme Court reiterated the long-established fiduciary duty of directors to act in good faith in the interests of the company, that is, the interests of its shareholders.

However, the closer a company is to insolvency, the greater the responsibility for directors to take into consideration creditors' interests. When a company is insolvent, bordering on insolvency or it is probable that it will enter into an insolvent liquidation (or other insolvency proceeding), or the directors knew or ought to have known that insolvency was imminent or it was probable the company would enter into an insolvent liquidation (or other insolvency proceeding), then creditors' interests become paramount as the company's shareholders no longer have a valuable interest in the company's assets. Critically, the Supreme Court held that the duty may exist even in circumstances where the relevant transaction was otherwise lawful, as was the dividend payment in that case.

Prudent directors should begin to consider early on what actions can be taken to resolve or mitigate any potential solvency issues, whether or not there is a prospect of recovery, a need to take legal advice or formal insolvency proceedings are warranted.

As highlighted in *Byers v Chen* [2021] UKPC 4 (BVI), directors must also be mindful of their fellow directors' actions, especially when the company is insolvent or nearing insolvency. The Board held that a director who knows that a fellow director is acting in breach of a duty or an employee is misapplying a company's assets must take reasonable steps to prevent those activities from occurring: inaction by failing to intervene to prevent such improper payments will result in their own breach of fiduciary duty, leaving them vulnerable to the voidable transaction provisions (discussed below).

Although the Board did not specify what "reasonable steps" directors should take to intervene in the actions of others, it is assumed that this means practical and/or legal action. Certainly, inaction will attract criticism. The requirement that directors police each other and incur the costs of doing so raises obvious practical difficulties, particularly in large and/or busy trading companies. It remains to be seen how far this point will be tested.

Insolvent trading

Insolvent trading is, in essence, a means for allowing the BVI Court to force directors to contribute to the company where their decision to try and keep the company running caused creditors a greater loss than if they had proceeded immediately with insolvency proceedings.

Under BVI law if a director "knew or ought to have concluded that there was no reasonable prospect that the company could avoid going into liquidation" then the Court can order any person to make such contribution to the assets of the company as the Court thinks proper.

There is a defence available - if the Court is satisfied that after the director first knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, the director took "every step reasonably open to [them] to minimise the loss to the company's creditors" then they will be protected from liability.

Voidable transactions

Under BVI law a transaction may be potentially voidable:

1. At the time of the transaction the company was insolvent, or the transaction caused it to become insolvent (excluding balance sheet insolvency); and

2. The company went into insolvent liquidation within the relevant vulnerability period (2 years for a transaction with a connected person or company, or 6 months in all other cases); and

3. The transaction puts a creditor of the company into a better position than they would have been in had the transaction not occurred (an ***unfair preference***); or

4. The company either gives a gift or receives no consideration, or the consideration which the company receives "the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company" (an ***undervalue transaction***).

There is no requirement for an "intention to prefer" for a transaction to be viewed as an unfair preference, however there is a saving provision that a transaction that took place in the ordinary course of business will not be an unfair preference. As a result, a number of transactions which might not be thought of as preferences in other jurisdictions may constitute preferences under BVI law. Case law has made clear that a director who breaches their duty by causing an unfair

preference may be held liable to the company, although such liability is likely to only be extended in serious cases (and if sums can be recovered from the party with the benefit of the preference, the liability of the director, if any, is likely to be limited to any shortfall). Clearly, however, directors of companies at, or close to, insolvency should be very careful about entering into new transactions.

For an undervalue transaction. again, there is a saving provision, being if the company enters into the transaction in good faith, for the purposes of its business, and at the time there were reasonable grounds for believing that the transaction would benefit the company.

There are also provisions relating to extortionate credit transactions and voidable floating charges.

Mitigation and next steps

The director's position in any subsequent claims will always be far stronger if the decisions being made, and the reasons for those decisions, are properly documented. Not every company needs to rush into insolvency, and there will be many once healthy companies that do have a reasonable prospect of recovering from financial troubles. Equally, it is not the purpose of the rules around either insolvent trading or misfeasance to punish directors who make commercially sound judgements that turn out to be wrong.

If, for example, the directors believe that the company has a reasonable prospect of staving off insolvency and decide to adopt a "wait and see" approach, it is sensible to record that they have considered the position and the reasons why they reached that determination. Meeting early and often can show that the directors' are taking the position seriously. If the directors decide to take legal advice, and follow that advice (and reliance on expert advice can be a defence to a breach of duty claim), again, they should ensure that advice is documented and referred to in board resolutions. There may well be a strong argument for directors taking independent advice rather than relying on counsel who have advised the shareholders or wider group.

If directors have the benefit of a D&O policy, they should consider whether (and at what point) they are required to notify their insurers of financial difficulty. Failure to notify at the right point could result in a loss or reduction of coverage. If they have an indemnity or service agreement, they should consider any relevant terms in that document as well.

For those companies that do need to enter into a formal insolvency or restructuring process, there are a range of tools available under BVI law including various types of liquidation (and provisional liquidations), a creditor's voluntary arrangement under the BVI's Insolvency Act and schemes and plans of arrangement. There are also a range of corporate restructuring tools for streamlining group structures, including mergers and acquisitions.

It is worth noting however that there are no "debtor in possession" insolvency proceedings equivalent to Chapter 11 in the US. Similarly, although the BVI legislature once passed provisions intended to introduce an administration process like that under English law, those have not been brought into force. The BVI has always been a friendly jurisdiction for secured lenders, and has historically been sceptical of debtor led processes which emphasise recovery and rehabilitation over creditor's rights.

The "right" restructuring process varies for each company and circumstance, and we would urge clients considering their options to seek BVI advice at an early stage.

Conclusion

Directors of any BVI company in financial difficulty, or which could face financial difficulty, should seek legal advice as soon as possible to ensure that they protect themselves and give their business the best prospect of survival.

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