Westlaw Today
powered by Reuters

The impact on the Cayman Islands, BVI and Bermuda jurisdictions following the 'momentous' decision of the UK Supreme Court in relation to directors' duties

By Luke Fraser, Esq., Jessica Williams, Esq., Jayson Wood, Esq., and Gerrard Tin, Esq., Harneys

JANUARY 30, 2023

Introduction

The Cayman Islands, BVI and Bermuda are frequently the jurisdiction of first choice for the incorporation of companies with commercial and other interests in other countries.

However, as common law jurisdictions which generate a much smaller body of case law compared to say England, the Cayman Islands, BVI and Bermuda pay particular heed to the decisions of other common law jurisdictions, in particular England.

The decisions of the English courts are not binding on these jurisdictions (save in respect of decisions of the UK Privy Council on appeal from the respective jurisdiction). However, these decisions are persuasive, particularly so when issued by the UK Supreme Court.

Unlike the UK, the Cayman Islands Companies Act does not contain a statutory provision on the duty of good faith.

One such case is the recent decision of the Supreme Court in *BTI 2014 LLC v Sequana SA and Others* (***Sequana***).[1] The judgment is described by one of the judges, and subsequently much-heralded, as "momentous" and confirms the existence of the common law duty of directors to have regard to the interests of the company's creditors where the company is insolvent or is approaching insolvency (the ***creditor duty***), and clarifies what that duty entails and when it is triggered.

Key findings

In *Sequana*, the UK Supreme Court considered for the first time and confirmed the existence of the creditor duty and further clarified that it is not a free standing duty owed directly to creditors. Rather, it falls within the duty owed by the directors to act in good faith in the interests of the company. While solvent, the directors must have regard to the shareholders in exercising the duty.

However, as the company nears insolvency, the directors' duty to the company is modified such that they must also have regard for the company's creditors. With respect to when the (modified) duty arises, the Court determined that the duty is engaged when the directors know or ought to know that the company is insolvent or bordering on insolvency (pushing the trigger point back from the Court of Appeal's formulation).

Common law and statutory basis for fiduciary duties in the United Kingdom

The fiduciary duty of directors to act in accordance with the best interest of the company has long existed at English common law.[2] The duty was (in a relative sense) recently given statutory expression in a modified form in section 172(1) of the UK Companies Act 2006. The provision "requires directors to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole".

A modification to the duty of good faith, that the actions of the directors must prioritise the interests of creditors over its members as the company approaches insolvency, was first articulated in the UK in the decision of *West Mercia Safetywear Ltd v Dodd and Another*.[3]

The creditor duty was also codified under section 172(3) of the UK Companies Act 2006 which records 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."

Cayman Islands

Application of the creditor duty

Unlike the UK, the Cayman Islands Companies Act (2022 Revision) does not contain a statutory provision on the duty of good faith.[4] Instead, the Courts rely on common law principles when considering the existence and application of fiduciary duties owed by directors.

Following the decision in West Mercia, the Grand Court of the Cayman Islands recognised that directors have a duty to consider creditors' interests when a company is nearing insolvency in *Prospect Properties Limited (in liquidation) v McNeill & Anor*.[5]

More recently, the Court of Appeal in *AHAB v SAAD Investments Company Limited*[6] stated that the creditor duty only arises when the directors know or should know that the company will probably become insolvent.

In doing so, the Cayman Islands Court of Appeal relied on the earlier decision in *BTI 2014 LLC v Sequana LLC*[7] stating that the summary of when the duty was engaged was "equally appropriate as a statement of the position under Cayman law".[8] Given the consistency of approach and previous application,[9] it seems inevitable that the Courts of the Cayman Islands will adopt the reasoning of the UK Supreme Court in *Sequana* when considering the application of the creditor duty.

The significance of the Supreme Court's decision in Sequana *in the BVI therefore is likely to centre on the point at which it was decided that the duty to consider the interests of the creditors arises.*

From a practical perspective, it is worth noting that the Court of Appeal in *Sequana* held that the creditor duty was engaged when the company is or is likely to become insolvent (i.e. it is of dubious solvency).

However, the Supreme Court's formulation is slightly different. The Court held that the duty is triggered when a company is actually insolvent or bordering on insolvency. The revised approach likely allows a company to operate closer to the edge of insolvency before considering the interests of creditors than was previously permitted under the position preferred by Court of Appeal.

Accordingly, directors of companies registered in the Cayman Islands may take some comfort in the fact that they are likely to have slightly more freedom to focus on rehabilitating a struggling company.

Insolvency test

One potential area of divergence between the UK Supreme Court and the approach ultimately adopted in the Cayman Island that may arise is whether "temporary commercial insolvency" triggers the creditor duty.

As detailed by the Cayman Islands Court of Appeal in *In re Weavering*,[10] the settled approach in the Cayman Islands is that the test for insolvency is a "cash-flow" analysis (is the company presently able to pay its debts when due?) as opposed to a "balance-sheet" test (do the company's assets overall exceed liabilities?).

In *Sequana*, Lady Arden commented that "temporary commercial insolvency" should be excluded from triggering the creditor duty as "it is obvious that there would be many directors to whom the Rule in *West Mercia* will apply".[11] Lord Briggs made similar observations in his judgment.[12]

In circumstances where the Courts of the Cayman Islands have almost exclusively relied on the "cash-flow" test to determine insolvency, it seems unlikely that judiciary would agree with Lady Arden and Lord Briggs that "temporary insolvency" would not trigger the creditor duty.

That being said, the Court of Appeal stated in *Weavering*[13] that the insolvency test is not confined to debts that are immediately due and payable, which may open the door to some consideration of a balance sheet test when considering whether the creditor duty is triggered in situations of temporary insolvency.

Such a broader approach to the concept of insolvency for the purposes of determining directors' duties would make sense since shareholders may still have a tangible financial interest in the liquidation of a "cash-flow" insolvent company, and hence, it would appear incongruous for directors to be required to ignore those interests.

BVI

Application of the creditor duty

As far as the statutory duty is concerned, the position is similar in BVI to England. The BVI Business Companies Act 2004 (***BCA 2004***) requires that directors, in exercising their powers or performing their duties, "*act honestly and in good faith and in what the director believes to be the best interests of the company*."[14]

Further, sections 120(2) and (3) of the BCA 2004 permit a director to act in the best interests of a parent company even if such actions are not in the best interests of the company itself if permitted to do so by the company's memorandum or articles. However, a director must have the prior agreement of shareholders if the company is not a wholly owned subsidiary.

The shareholders of joint ventures may also receive preferential treatment by directors at the expense of the company, subject to the company's memorandum or articles.[15] Further, section 121 BCA 2004 requires that: "*a director shall exercise his powers as a director for a proper purpose and shall not act, or agree to the company acting, in a manner that contravenes this Act or the memorandum or articles of the company*."

With respect to creditors' rights, the Eastern Caribbean Court of Appeal cited West Mercia with approval in 2013 in the unreported case of *MacKeller v Khoo Kin Yong et al.*[16] Baptiste JA noted (at [36]) that the directors of the insolvent company should have taken its creditors interests into account when making their decision.

Relevantly, the Privy Council recently confirmed the existence of the creditor duty in the BVI in the case of *Byers v Chen*.[17] Lord Kitchin imputed the creditor duty to the 'proper purpose' requirement under section 121 of the BCA 2004 when he stated that the director should have exercised "*her powers as a director for proper purposes*": such purposes, he stated, included furthering the interests of the company's creditors.

It was also noted that the ultimate beneficial owners of the company could not ratify a waiving of this duty, emphasising its primacy over a duty to shareholders once the company reaches the point of insolvency. Accordingly, *Sequana* added little to BVI jurisprudence as far as the recognition of the creditor duty is concerned. Indeed, Lord Briggs referred to the decision in *Byers v Chen* in his judgment in *Sequana*.

The significance of the Supreme Court's decision in *Sequana* in the BVI therefore is likely, as in the Cayman Islands, to centre on the point at which it was decided that the duty to consider the interests of the creditors arises. This is particularly so given the Privy Council in *Byers v Chen* did not consider the question of when the creditor duty is engaged.

Unlike the Cayman Islands, the Bermuda test for insolvency is not limited to "cashflow."

Rather, the Court noted that the company had gone into insolvent liquidation a number of years before the payment of the dividend which was made in breach of, *inter alia*, the creditor duty. Although not directly binding, we anticipate the BVI Court will follow the UK Supreme Court's decision in *Sequana* in relation to when the creditor duty is engaged.

Insolvency test

The BVI test for insolvency is set out in section 8(1) of the BVI Insolvency Act 2003. A company is insolvent if: (a) it fails to comply with a statutory demand which has not been set aside; (b) it does not satisfy its debt to a judgment debtor (in whole or in part); and (c), either (i) its liabilities exceed its assets or (ii) it is unable to pay its debts as they fall due (described by Wallbank J in *PT Ventures, SGPS, SA v Vidatel Limited*[18] as the "cash flow test" of insolvency). Lord Reed observed (at [87] of *Sequana*) that a director needs clear standards to guide them: the BVI insolvency test is quite unambiguous.

Bermuda

Application of the creditor duty

Unlike the Cayman Islands, Bermuda makes provision for a director's fiduciary duties under s 97 of the Bermuda Companies Act 1981. Sections 97(1) and (4)(b)(i) give statutory effect to the common law fiduciary duties imposed on directors with section 97(4)(b)(i) importing the duty of loyalty.

The leading Bermuda decision concerning the duties of directors when "*a company becomes insolvent or is nearly so*" is *Re First Virginia Reinsurance Ltd*.[19] In that case, taking a very similar line of reasoning to that of the Supreme Court in *Sequana*, Kawaley J notes the primary duties set out in section 97 (1) of the Bermuda Companies Act are generally accepted as reflecting the common law. Justice Kawaley goes on to set out the basis for the creditor duty, noting that.[20]

This practice flows from the umbrella core principle of both corporate and personal insolvency law, that neither shareholders nor the bankrupt may participate in distributions from the estate until creditors are paid in full.

It is worth noting that the ability of directors to be indemnified against liability in the bye-laws (Articles) of a Bermuda company is more wide ranging than in the BVI, the Cayman Islands, and the United Kingdom.

Under section 98 of the Bermuda Companies Act, directors are permitted to be indemnified in respect of all liability which might attach to them other than liability for fraud or dishonesty. As a matter of course, the bye-laws of a Bermuda company will expressly indemnify directors against liability for breach of duty and breach of trust (as well as negligence and default).

As a result, there is unlikely to be a large body of local case law generated which deals with the duties of directors when a company nears insolvency when compared to say the UK where any provision (in the Articles or otherwise) which purports to exempt a director from liability for breach of duty or breach of trust (or negligence or default) is void.

Insolvency test

Unlike the Cayman Islands, the Bermuda test for insolvency is not limited to "cashflow" and regard is had to the financial position of the company as a whole including its balance sheet.[21] Accordingly, the judiciary in Bermuda may find favour with the comments of Lady Arden and Lord Briggs that "temporary insolvency" would not trigger the creditor duty.

Concluding remarks

The significance of the *Sequana* decision is that it confirms, at the highest judicial level, the existence of the creditor duty. Importantly, it clarifies the scope of the duty and the point at which it is triggered, departing from and pushing back the trigger point identified in the Court of Appeal which will have implications in offshore jurisdictions.

The existence of the duty has never been in doubt in recent years, but the clarification is a welcome development and highly persuasive in the Cayman Islands, BVI and Bermuda jurisdictions. Nonetheless, it remains to be seen whether the newly defined parameters of the duty, and especially the timing for imposition of the duty, will change the previous *West Mercia* approach in any practical sense.

Notes

[1] [2022] UKSC 25.

[2] See, for example, *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, 671.

[3] [1988] BCLC 250. In reliance on the judgment of the New South Wales Court of Appeal in *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722.

[4] However, there are a number of provisions which enable the Court to reverse transactions that took place prior to insolvency which are consistent with the rationale behind the duty being engaged when a company is bordering on insolvency. See, for example, sections 99, 134(1), 145 and 146 of the Companies Act (2022 Revision).

[5] [1990-91 CILR 171].

[6] (21 December 2021, unrep, CICA (Civil) 15 of 2018).

[7] [2019] 2 All ER 784.

[8] At paragraph 684.

[9] See also *In the Matter of Global Fidelity Bank, Ltd*. (In voluntary liquidation) (Unrep, Grand Court, 20 August 2021) (Cayman).

[10] [2016] (2) CILR 514.

[11] At paragraph 309.

[12] at paragraph 173.

[13] At paragraph 40.

[14] Section 120(1) BCA 2004.

[15] Section 120(4) BCA 2004.

[16] VIHCMAP2013/0008 (4 April 2016).

[17] [2021] UKPC 4 at paragraph 91.

[18] BVIHCM2021/0039 (30 September 2021) (unreported).

[19] [2003] Bda LR 47.

[20] At page 7.

[21] *re Gerova Financial Group Limited* [2012] Bda LR 20 per Kawaley J at paragraphs 30–31.

About the authors




(L-R) **Luke Fraser** is an associate in **Harneys**' litigation, insolvency and restructuring team in the Cayman Islands. He has a broad range of experience and specializes in complex litigation, enforcement, asset tracing, and civil recovery. He can be reached at luke.fraser@harneys.com. **Jessica Williams** is a partner in the firm's litigation, insolvency, and restructuring practice group in the Cayman Islands. Her practice focuses on insolvency and restructuring, trust and estate litigation, shareholder disputes, and asset-tracing and enforcement. Her clients include financial institutions, high-net-worth individuals, insolvency practitioners, trustees, court appointed administrators, and other officeholders. She can be reached at jessica.williams@harneys.com. **Jayson Wood** is a partner and the head of firm's Bermuda litigation and insolvency practice. He is experienced in all aspects of corporate and insolvency litigation, with particular Cayman Islands and Bermuda expertise in cross-border debt restructurings of distressed companies, hedge fund collapses, shareholder disputes, corporate fraud, receiverships/liquidations, asset preservation and corporate reconstruction. He can be reached at jayson.wood@harneys.com. **Gerrard Tin** is an associate in the litigation, insolvency and restructuring team in the firm's British Virgin Islands office. He has broad commercial litigation experience with a focus on insolvency litigation, shareholders' disputes, fraud, asset tracing and financial services litigation. He has particular expertise in the enforcement of security and the bringing and defending of liquidation proceedings. He can be reached at gerrard.tin@harneys.com. The authors would like to thank partner Claire Goldstein for her contribution to this article.

This article was first published on Westlaw Today on January 30, 2023.