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Director's duties and insolvency: Sequana – an offshore perspective

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Synopsis

The UK Supreme Court's judgment in the case of **BTI 2014 LLC v Sequana SA & Ors [2022] UKSC 25** (*Sequana*) is a landmark decision of significant importance in the arena of company law and directors' duties.

It provides welcome clarification from the UK's highest court on issues that are of key importance to directors of companies in financial difficulty, addressing:

- the existence, application and scope of the so-called "creditor duty",
- the circumstances in which the otherwise lawful approval of a distribution might give rise to liability, and
- the scope of the doctrine of shareholder ratification.

This note briefly summarises the decision and provides insight into its likely application by the courts in Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey and Jersey, noting the ways in which the respective statutory regimes in place in those jurisdictions differ in important respects from the UK's company legislation, particularly in relation to the approval of distributions.

Sequana – Summary of the facts

The case concerned a decision taken by directors of a company called AWA in May 2009 to approve a dividend distribution to its parent company and sole shareholder Sequana SA in circumstances where AWA had contingent liabilities arising from long-term environmental obligations, which were uncertain as to their likelihood to arise and as to quantum.

The distribution was lawfully approved by the directors and at the time the 2009 dividend was paid, AWA was solvent on both a balance sheet and cash flow basis. Several years later, in 2018, the contingent liabilities crystallised, and AWA was then deemed insolvent and entered administration.

Claims were brought by BTI 2014 LLC (**BTI**), an assignee of AWA, seeking recovery of the dividend amount from the directors, on the basis that the distribution was made in breach of the "creditor duty", and by another of AWA's creditors to set aside the distribution on the basis that it was a transaction at an undervalue.

Both the English High Court and Court of Appeal rejected the creditor duty claim and BTI subsequently appealed to the Supreme Court.

Decision of the UK Supreme Court

The much awaited judgment provided the first opportunity for the Supreme Court to consider the existence, application and scope of the so-called "creditor duty" of company directors as well as considering the circumstances in which the otherwise lawful approval of a distribution by directors might give rise to liability, and the scope of the doctrine of shareholder ratification with respect to prior actions of directors.

Existence of the "creditor duty"

The "creditor duty", otherwise referred to as the rule in *West Mercia* (taken from the leading decision of the English Court of Appeal in 1988), is the duty of company directors to consider, or to act in accordance with, the interests of a company's creditors when the company becomes insolvent, or when it approaches or is at real risk of insolvency.

In *Sequana,* the Supreme Court considered, as a preliminary question, whether the creditor duty existed at all.

The Court decided unanimously that the duty did exist (referring to the *"impressive unity of the authorities"* in this area) and that the duty arises as a modification of the long-established common law fiduciary duty of a director to act in good faith in the interests of the company.

The Court also held unanimously that the "creditor duty" is not a free-standing duty of its own that is separately owed to creditors but an aspect of the directors' duty to the company.

Application and scope of the creditor duty

The Court found in this case that the directors were not in breach of the creditor duty and dismissed BTI's appeal.

However, in dismissing the appeal, the Court made the following key findings in terms of the scope or "content" of the creditor duty:

- The Court disagreed with the Court of Appeal's view that the creditor duty is triggered simply because insolvency is probable (i.e. it is more likely than not to occur), holding that the creditor duty does not arise merely because the company is at real risk of insolvency which is neither probable nor imminent.
- Rather, the Court's position was that the creditor duty is engaged when directors know, or ought to know, that the company is insolvent or bordering on insolvency, or that an insolvent liquidation or administration is probable.
- The Court held that it was not correct that the interests of creditors are necessarily paramount when a company is insolvent or bordering on insolvency, but liquidation or administration has not become inevitable. In this scenario:
    - Directors should consider the interests of creditors and balance them against the interests of shareholders where they may conflict.
    - The greater the company's financial difficulties, the more the directors should prioritise the interests of creditors.
    - However, where an insolvent liquidation or administration is inevitable, creditors' interests become paramount as from that point the shareholders cease to retain any valuable interest in the company.

The Court also noted that directors should bear in mind that they are under a duty to keep themselves informed about the company's affairs and the rule in *West Mercia* should *"itself incentivise directors to keep the solvency of the company under careful review".* [1]

In giving the Judgment, the Court also highlighted the need for company directors to be given *"clear guidance",* noting that *"company law must be ascertainable and applied in real time"* and that decisions of the directors *"must be taken immediately and cannot await the comparatively leisurely course of litigation"* [2]. The Court further noted that *"judicial development of company law should not trespass on... or undermine the operation of insolvency [law]"* [3].

Application to lawful distributions

Having verified the existence of the creditor duty, the Court went on to consider whether that duty could apply to a decision by directors to pay a dividend which is otherwise lawful.

The Court unanimously ruled that it could.

This is because UK company law allows a distribution to be made from profits available on a balance sheet basis, leaving open the possibility that a company could lawfully pay a dividend whilst solvent on a balance sheet basis but insolvent on a cashflow basis.

Shareholder ratification

The Court also ruled that the creditor duty was not inconsistent or incompatible with the ratification principle, which can protect directors against claims for breach of duty where the company's shareholders have ratified the breach in cases where the breach of duty affected the shareholders.

However, the Court took a unanimous view that the ratification principle does not conflict with the recognition of the creditor duty but that it could not apply to decisions made at a time when a company is insolvent or which render the company insolvent, where the interests at risk were those of the creditors. In such circumstances, shareholders do not have the power or authority to absolve directors from a breach of duty to the creditors as they lack the necessary economic interests at the point of insolvency.

Application of *Sequana* in offshore jurisdictions

A key part of the analysis in *Sequana* focussed on the meaning and effect of various provisions of the English Companies Act 2006, and the interplay between the English statutory regime applicable to directors' duties and the common law. In particular, section 172(3) of the UK Companies Act 2006 expressly recognises the existence at common law of the creditor duty.

As Overseas Territories and Crown Dependencies of the UK, English Supreme Court decisions are persuasive, but not binding, in Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey and Jersey.

We consider below how the reasoning in *Sequana* may be applied by the courts in each of Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey and Jersey, in circumstances where the relevant statutory regimes relating to company and insolvency law differ from those currently in place in the UK.

Bermuda

Creditor duty

Section 97 of the Companies Act 1981 of Bermuda (**CA 1981**) confirms a statutory duty of directors to act in the best interests of the company.

1 Para 90 of the Judgment
2 Para 448 of the Judgment
3 Para 6 of the Judgement

Continued

The Bermuda Court held i*n Re First Virginia Reinsurance Ltd.* [2003] Bda LR 47, that the statutory duty contained in Section 97 of the CA 1981 to act in the best interests of the company means, in the context of an insolvent company, a duty to act in the best interest of creditors. The Bermuda Court's reasoning is based on a remarkably similar statutory and common law analysis to that adopted by the UK Supreme Court in *Sequana.*

The principle set out in *Re First Virginia Reinsurance Ltd* regarding creditor duties has been adopted and applied by the Bermuda Courts so frequently since this decision that it is often stated without citation.

The clarification in *Sequana* as to when the creditor duty is engaged based on the Supreme Court's determination that the creditor duty is engaged when the directors know, or ought to know, that the company is insolvent or bordering on insolvency, or that an insolvent liquidation or administration is probable[4] is expected to be applied in Bermuda.

It is also likely that in the Bermuda context, the Bermuda Courts will consider the probability of a light touch provisional liquidation as engaging the creditor duty, as provisional liquidation has been expressly held by the Bermuda Courts to be analogous to administration under English Law.

Application to lawful distributions

The Supreme Court's reasoning in *Sequana* to the circumstances in which a dividend may become unlawful, is unlikely to have a significant impact in Bermuda.

Section 56 of the Companies Act 1981 of Bermuda expressly provides that a company shall not declare or pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that the company is, or would after the payment be, unable to pay its liabilities as they become due or the realizable value of the company's assets would thereby be less than its liabilities.

Statutory provisions in relation to the payment of dividends are construed strictly in Bermuda (see e.g. the decision of the Bermuda Court of Appeal in *Belvedere Insurance Company Ltd ((in Liquidation)) v Caliban Holdings Ltd* [2001] Bda LR 2).

Accordingly, the Supreme Court's formulation of the attachment point for the creditor duty (i.e. when the directors know, or ought to know that the company is insolvent or bordering on insolvency) and the statutory test under Section 56 of the Companies Act 1981 are very likely to be co-extensive in virtually every case.

Shareholder ratification

It is likely that the position taken in *Sequana* that shareholders cannot ratify a breach of duty to creditors in insolvency scenarios would be applied in Bermuda.

British Virgin Islands

Creditor duty

There are no reported decisions of the BVI Courts where the rule in *West Mercia* has been expressly applied, although it is generally accepted that BVI common law does recognise a duty equivalent to the creditor duty established by that rule.

The BVI Business Companies Act 2004 ("**BCA**") does not contain a detailed set of provisions equivalent to those in section 172 of the English Companies Act 2006, and there is no express reference to directors needing to take creditors' interests into account, although the common law relating to directors' duties undoubtedly applies and so the Supreme Court's confirmation that the creditor duty exists under common law puts this question beyond doubt.

However, section 120 of the BCA expressly allows directors to act in the interests of a shareholder in certain circumstances, even where to do so may not be in the best interests of the company itself. Although subject to inclusion in the company's constitutional documents and in some cases shareholder consent, these provisions can apply to subsidiary companies (allowing directors to act in the best interests of the parent), and to joint venture companies (allowing directors to act in the interests of the shareholder who appointed them).

Perhaps surprisingly, the meaning and scope of section 120 of the BCA and related provisions (which have no equivalent in English company law) has never been considered by the BVI Courts, but there is potential for tension between these provisions and the application of the creditor duty, which the UK Supreme Court has now held to be part of the fiduciary duty owed by directors to the company.

There is therefore clearly scope for argument that the creditor duty is qualified in the BVI where this unique "shareholder duty" is engaged, given the seemingly unambiguous wording of section 120 of the BCA, allowing directors to act in the interests of a shareholder even where that is not in the interests of the company.

Application to lawful distributions

The Supreme Court's reasoning in *Sequana* to the circumstances in which a dividend may become unlawful, is unlikely to have a significant impact in the BVI.

Unlike the position in the UK which, as noted above, allows a dividend to be paid from profits available on a balance sheet basis, the directors of a BVI company can only declare a dividend if, **immediately after the payment of the dividend**, the company can satisfy the statutory solvency test set out at section 56 of the BCA – being whether the company is both able to pay its debts as they fall due (cash flow test) **and** the value of its assets is greater than the value of its liabilities (balance sheet test).

The application of the common law creditor duty is therefore of less practical relevance to the authorisation of distributions in the BVI, where the focus of the Court's inquiry would more likely be on the engagement of the statutory provisions in the BCA, rather than the question of whether the decision prejudiced the interests of creditors.

4 *Para 203, 231 of the Judgment*

Continued

Shareholder ratification

It is likely that the position taken in *Sequana* that shareholders cannot ratify a breach of duty to creditors in insolvency scenarios would be applied in the BVI. This is a logical corollary of the Privy Council's decision in *Ciban Management Corporation v Citco (BVI) Ltd and another* [2020] UKPC 21, which confirmed that an act authorised by a sole shareholder under the Duomatic principle "*must not jeopardise the company's solvency or cause loss to its creditors".*

Cayman Islands

Creditor duty

Directors' duties have not been codified into legislation in the Cayman Islands, and instead arise under common law.

The Cayman Courts have previously accepted that the creditor duty applies to directors of Cayman companies, and there is an existing body of case law recognising the duty.

The duty as set out in *West Mercia* had been recognised by the Grand Court in *Prospect Properties Limited v McNeill* [1990–91 CILR 171], and in the recent Cayman Islands Court of Appeal judgment in *AHAB v SAAD Investments Company Limited* (21 December 2021, unreported, CICA (Civil) 15 of 2018), the Court of Appeal referred to the English Court of Appeal's decision in the *Sequana* case. The Court of Appeal in *AHAB* stated that the finding in *Sequana* that the creditor duty only arises when the directors know or should know that the company will probably become insolvent, was equally appropriate as a statement of the position under Cayman law.

Accordingly, the Cayman Courts will in all likelihood follow the UK Supreme Court judgment in *Sequana* as it relates to the creditor duty.

However, it is also possible that in the Cayman context, the Cayman Courts will consider the probability of a light touch provisional liquidation and/or the application by directors to appoint a restructuring officer (under the new restructuring regime in the Cayman Islands) as engaging the creditor duty by reference to the determination in *Sequana* that clarifies when the creditor duty is engaged.

Application to lawful distributions

The Supreme Court's reasoning in *Sequana* to the circumstances in which a dividend may become unlawful, is unlikely to have a significant impact in the Cayman Islands.

This is because the legal framework for the payment of distribution or dividends to shareholders, which is set out in section 34 of the Cayman Companies Act (2022 Revision), already provides that such a payment by a company to its shareholders is not lawful unless **immediately following the date on which the payment is proposed to be made** the company shall be able to pay its debts as they fall due in the ordinary course of business. It is a criminal offence on the part of the directors or managers of the company if the company makes such a payment when it is not able to pay its debts.

The *Sequana* judgment will likely therefore be of less practical relevance to distributions by Cayman companies as the focus of the Cayman Court's inquiry would more likely be on the engagement of the statutory provisions in the Cayman Companies Act (2022 Revision), rather than the question of whether the decision prejudiced the interests of creditors.

Shareholder ratification

It is likely that the position taken in *Sequana* that shareholders cannot ratify a breach of duty to creditors in insolvency scenarios would be applied by the Cayman Courts.

Guernsey

Creditor duty

The judgment in *Sequana* is likely to be highly relevant to the law on directors' duties in Guernsey.

Although many of the issues covered in the decision focus on matters of English statutory company law which do not have direct application to Guernsey, the Supreme Court's overall guidance on the content and engagement of the creditor duty is likely to be highly persuasive in cases which come before the Guernsey Royal Court.

The Royal Court's landmark judgment in *Carlyle* in 2017 made clear that the creditor duty does exist under Guernsey law. Therefore, it seems likely that the guidance in *Sequana* as to the scope and application of the creditor duty will be followed in Guernsey.

Application to lawful distributions

The Supreme Court's reasoning in *Sequana* to the circumstances in which a dividend may become unlawful, is unlikely to have a significant impact in Guernsey.

Unlike the position in the UK which, as noted above, allows a dividend to be paid from profits available on a balance sheet basis, in Guernsey a company can only declare a dividend if **immediately after the payment of the dividend** it can satisfy the statutory solvency test at section 527 of the Companies (Guernsey) Law, 2008, namely it is able to pay its debts as they become due (cash flow test) **and** the value of its assets is greater than the value of its liabilities (balance sheet test).

Shareholder ratification

The finding in *Sequana* that shareholders cannot ratify an act or decision of directors taken when the company is insolvent, or which causes the company to become insolvent, or in connection with a breach of duty to creditors in insolvency scenarios, is likely to be persuasive in Guernsey.

Jersey

Creditor duty

The position adopted by most Jersey Advocates would be one where the creditor duty was said to exist and reference to the creditor duty is frequently put to, and accepted by, the Jersey Court albeit in the absence of any specific current local authority to evidence this.

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The UK Supreme Court's confirmation of the existence of the "creditor duty" in *Sequana* is therefore very useful in reinforcing this point as the Jersey Courts, in a matter such as this, will regard decisions of the UK Supreme Court as highly persuasive.

Application to lawful distributions

The Supreme Court's reasoning in *Sequana* to the circumstances in which a dividend may become unlawful, is unlikely to have a significant impact in Jersey.

Unlike the position in the UK which, as noted above, allows a dividend to be paid from profits available on a balance sheet basis, in Jersey, a distribution under the Companies (Jersey) Law 1991 is an unlawful distribution unless the directors who are to authorize the distribution make a statement confirming that the company is (cash flow) solvent at the time of the distribution and further that it can continue to carry on its business and be (cash flow) solvent for a look forward period of 12 months.

The principle in *Sequana* that a decision to pay a dividend that is lawful under the statutory distribution provisions may still be taken in breach of duty, re-affirms our view that directors of a Jersey company could breach their duties by authorising a distribution that causes the company to become insolvent in the future even if they comply with the formal statutory requirements for a lawful distribution.

Shareholder ratification

The points addressed in *Sequana* on shareholder ratification are less likely to be of significance in Jersey.

Shareholder ratification of directors' acts is possible under Companies (Jersey) Law 1991 but only where the appropriate resolutions are passed and where the company will be (cash flow) solvent after the time when the act or omission to be ratified occurs.

The solvency requirement in the ratification procedure aligns with the principle in *Sequana* that there can be no shareholder ratification of a transaction entered into when the company is insolvent, or which would render the company insolvent.

Conclusion

The *Sequana* judgment has provided welcome clarification on the role of the creditor duty as a matter of company law and its impact on the factors that company directors must consider when discharging their duties, particularly in these challenging economic times.

Whilst the specific scope and statutory basis for director duties, distributions and shareholder ratification may differ across the various offshore jurisdictions we have highlighted in this piece, the *Sequana* decision will likely be treated as highly persuasive across the offshore courts and provides valuable and helpful additional guidance to directors of offshore companies facing financial difficulty.

A key practical take-away from *Sequana* is the importance of directors to keep clear financial records to allow them to properly assess the solvency of the company on an ongoing basis and to accurately record their decision making to note the varying extent to which they balance the interests of their shareholders with the interest of their creditors as the financial difficulties the company faces evolve.

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