Directors' duties in the zone of insolvency: An offshore view

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In this article we explore the UK Supreme Court's ("the **Supreme Court"**) decision in *BTI v Sequana*[1] and what this means for directors in Jersey - particularly when dealing with a company which is facing the onset of insolvency.

Jersey is a customary law jurisdiction (based on Norman French principles) supplemented by local statute. However, the primary companies legislation, the Companies (Jersey) Law 1991 (as amended) ("the **CJL"**), is based on the United Kingdom's Companies Act 1985. Consequently, although not binding, decisions of the English and Commonwealth Courts are generally persuasive where there is an absence of local authority.

A general summary of directors' duties

Article 74 (1) of the CJL provides that:

"*(1) A director, in exercising the director's powers and discharging the director's duties, shall:*

(a) act honestly and in good faith with a view to the best interests of the company; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

Directors of Jersey companies are under a fiduciary duty to act *bona fide* in the best interests of the company by reference to the shareholders as a whole. These duties encapsulate customary law derived fiduciary duties of directors.

When considering the duties owed by directors of a Jersey company, the Royal Court of Jersey ("the **Jersey Court"**) will have regard to both local and English case law.

When determining whether a director has acted honestly and in good faith, the Jersey Court will adopt a subjective test, such that it is for the directors to determine what is in the company's best interests and not the Jersey Court.

However, even applying a subjective test, the Jersey Court might be persuaded to infer that a director did not consider the action to be in the company's best interests where it forms the view that no reasonable and honest director could have concluded a particular action to be in the company's best interests, taking into account all of the circumstances of the relevant transaction.

A director of a Jersey company must exercise reasonable care that an ordinary man might be expected to take in the same circumstances.

A director of a Jersey company must also exercise their powers for a proper purpose, for which the power has been conferred.

Breaching those duties

In general terms, the consequences of a breach of a director's statutory or customary law duties include, depending on the duty which has been breached, an order that the:

- relevant transaction is set aside;
- director must return the relevant property to the company;
- director must compensate the company for any loss suffered as a result of the breach; and/or
- director must pay the company any profit or gain made by the director.

Directors' duties in the onset of insolvency

A Guernsey perspective:

The synergy between protecting shareholder and creditor interests was usefully analysed by the Royal Court of Guernsey ("the **Guernsey Court"**), in which the following principles can be taken:[2]

- a director's duty to look out for the creditors' interests is subsumed into the duty of good faith;
- the basis of such duty is that, when a company is, or is nearly, insolvent, any assets it has belong to the creditors, rather than the shareholders;
- the creditors have first call on those assets towards the satisfaction of their debts; and
- this will translate into hard practicality if there is a liquidation.

In its reasoning above, the Guernsey Court had regard to the decision of the Supreme Court in *Bilta (UK) Ltd v NAZIR (No 2)* [3] where the following was observed:

- the fiduciary duties of a director of a company which is insolvent or bordering on insolvency differ from the duties when a company is able to meet its liabilities;
- in the case of the former (an insolvent company), the director's duty towards the company requires them to have proper regard for the interest of its creditors and prospective creditors;
- in the latter (a solvent company), the shareholders, as a general body, can authorise or ratify a particular action of the director, so there can be no challenge to the validity of what the directors have done;
- where a company is insolvent, the company's assets are, in a practical sense, the creditors' assets and not the shareholders' assets;

- in an insolvency those assets are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration;
- the protection which the law gives to the creditors of an insolvent company, while it remains under the directors' management, is through the medium of the directors' fiduciary duty to the company; and
- in such a situation, the company's interests are not to be treated as synonymous with those of the shareholders but rather those of the creditors.

The UK perspective:

In the recent case of *BTI v Sequana*[4], the Supreme Court largely confirmed the position of the Guernsey Court. The key points, taken from one of the leading judgments,[5] are as follows:

- English law recognises that there is a common law 'creditor duty';
- the concept of this duty does not create a free-standing duty owed to creditors by directors: it merely recognised that, at the point of insolvency, the long-established fiduciary duty of directors to act in good faith in the best interests of the company meant (in insolvency) the interests of the creditors, which were not necessarily aligned with those of the shareholders;
- when the duty is owed, directors are required to have proper regard to the interests of creditors and prospective creditors, along with those of shareholders;
- a breach of the creditor duty cannot be ratified by a decision of the shareholders;
- the weight to be given to creditors' interests, in so far as they may conflict with those of shareholders, will increase as the company's financial situation becomes more precarious (i.e., it's a sliding scale);
- the Supreme Court rejected the argument that the 'creditor duty' is triggered when there is simply a 'real risk' of insolvency (predominantly because the risks of insolvency can change and fluctuate over time). Instead, the 'creditor duty' was held to be triggered when the directors know or ought to know that:
    - the company is actually insolvent;
    - the company's insolvency is imminent; or
    - an insolvent administration or liquidation is probable (which has similarities to the action of 'wrongful trading' under article 177 of the CJL where a director allows a company to carry on business when there was no reasonable prospect of an insolvency process being avoided).

Practical considerations

Financial analysis:

- Whether a Jersey company is deemed insolvent depends on whether it can pay its debts as they fall due. This is known as the 'cash flow' test.
- Directors should ensure that they are fully informed of the company's financial position at all times to ensure they are aware of the solvency status of the company. The importance of this responsibility was specifically emphasised by the Supreme Court.
- All factors which may impact on that status require to be taken into account when assessing the solvency position, so it is important that directors have access to all information necessary to have a complete picture of the company's affairs.

Balancing interests

- Beware of taking an overly cautious approach. Placing creditors' interests before shareholders at too premature a stage may give rise to claims from shareholders.
- If the company is insolvent or bordering on insolvency, the directors must have regard to the interests of the creditors, balancing those against the interests of the shareholders, where they may conflict.
- As the company's financial difficulties increase, so too does the weight that the directors must give to creditors' interests. However, the duty to creditors' only becomes 'paramount' when the company is insolvent or its insolvency is inevitable.

Decision making

- The decisions of directors during this time may well be scrutinised. It is therefore important that the decision making process is properly documented. That is particularly so if concerns as to the company's solvency arise.
- It would be advisable for directors to seek legal and accountancy advice when the company's solvency comes into question. This will help ensure they meet all duties incumbent upon them, and reduce the risk of legal challenge at a later stage.

Conclusion

The 'creditor duty' has yet to be addressed by the Jersey Court, although it is safe to say that the 'creditor duty' (or a very similar concept) exists in Jersey. When the time comes to grapple with the subject, the Supreme Court and Guernsey Court's decisions in *Sequana*[6] and *Carlyle*[7] respectively, will be relevant and persuasive.

The 'creditor duty' and, in particular, the practical difficulties arising from a sliding scale of considerations between shareholders and creditors, depending on the company's financial difficulties, might well give directors cause for concern. However, the 'creditor duty' is narrower than first thought and the cash flow test (being the prevailing insolvency test in Jersey) is typically simpler to assess than a balance sheet test. The duty is also heavily fact specific, with the Supreme Court noting that directors can begin protecting themselves from potential exposure by simply staying up to date with the company's financial position.

[1] BTI 2014 LLC v Sequana SA and others [2022] UKSC 25

[2] Carlyle Capital Corporation Limited (In Liquidation) and others v Conway and others [2017] Civil Action No. 1510 per Her Honour Hazel Marshall Q.C. Lieutenant Bailiff

[3] Bilta (UK) Ltd v Nazir (No 2) [2016] AC 1

[4] BTI 2014 LLC v Sequana SA and others [2022] UKSC 25

[5] Given by Lady Arden

[6] BTI 2014 LLC v Sequana SA and others [2022] UKSC 25

[7] Carlyle Capital Corporation Limited (In Liquidation) and others v Conway and others [2017] Civil Action No. 1510 per Her Honour Hazel Marshall Q.C. Lieutenant Bailiff

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