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Companies at risk of insolvency: directors' duties

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The Issues we are going to consider:

- Directors' duties where there is insolvency risk
  - When is the duty engaged?
  - What does the duty require?
- By reference to 2 cases – ***BTI v Sequana***, CA and ***Burnden Holdings v Fielding***, Zacaroli J

The facts of ***Sequana***, very briefly

- The Company had an indemnity liability – very large, very uncertain, very long-term
- It had a provision for that liability in the accounts – a best estimate only
- There was a risk that it would prove too low
- Dividends of €578m were paid

The fiduciary duty relating to creditors' interests

- Under English law, fiduciary duties of directors have been codified in the CA 2006
- In ***Sequana*** the questions of the trigger for the creditors' interests duty arose in that context
- The most important duty is in s172(1) CA 2006 – to promote the success of the company for the benefit of shareholders
- But that is subject to s172(3) CA 2006 preserves the common law – any duty "*to consider or act in the interests of creditors*"
- So the questions are, at common law
  - When does that duty arise?
  - What does the duty require?
- But the Jersey statute on directors' duties is different
- S74(1) Companies (Jersey) Act 1991
  - refers to a duty 'to act honestly and in good faith with a view to the best interests of the company',
  - makes no reference to the preservation of common law duties

- Note that, although most other breaches may be ratified by the shareholders, a breach of this duty is unratifiable by shareholders under English law
- But under s74(2) and (3) ratification is possible provided afterwards the company 'will be able to discharge its liabilities as they fall due' – which appears to be a cashflow test

The CA in ***Sequana*** held on the trigger test that

- The duty arises when
  - the directors know or should know
  - that the company is or is likely to become insolvent
- 'Likely' means – '*probable*' – more than 50%
- Not likely as in 'real likelihood' in ***Harris Simons*** [1989] 1 WLR 368
  - ie ***Liberty International*** [2010] 2 BCLC 665 – '*some way up the probability scale, beyond the merely possible, but short of the probable*'
- This refers to either balance sheet or cashflow insolvency
- Rejected the following alternative tests:
  - Actual insolvency, since it is difficult in practice to identify the point of actual insolvency, and it is too strict anyway
  - On the verge of or near to insolvency, because it is too demanding - insolvency does not have to be imminent
  - Real risk of insolvency, because it is too liberal and would have "*a chilling effect on entrepreneurial activity*"

How will the CA's trigger test be applied in practice?

- Take an example:
  - Non-trading company, with assets more than sufficient to pay it undisputed debts
  - But it has a very large disputed debt which it can't pay
  - That claim has gone to appeal and the company has 40% risk of losing the appeal
  - Can it pay a dividend?

- Change the example slightly:
  - The company is still trading
  - The directors want to invest its surplus cash in a new venture, within the usual scope of its business, entailing a normal level of risk

  - Can they, or must they 'put the money under the mattress'?
- So the content of the duty matters
- And the trigger test may be too strict
- The case goes to the Supreme Court in March 2020 on both those points

Application of the trigger test

- Test is whether a company is unable to pay its debts
  - In England, that requires consideration of two tests:
  - Cashflow test – s.123(1)(e) IA 1986
  - Balance sheet test – s.123(2) IA 1986 – see ***BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc*** [2013] 1 WLR 1408
- Jersey legislation appears only to refer to the cashflow test (similar to other jurisdictions such as Australia)

Difficulties in showing balance sheet insolvency

- ***Burnden Holdings (UK) Ltd v Fielding*** [2019] EWHC 1566 (Ch) where company a holding company.
- Consideration of forecasts relevant in determining valuation of guarantees and recoverability of intra-group indebtedness.

Content of the duty

- Are creditor interests paramount – ***Colin Gwyer*** [2003] 2 BCLC 153 at [74]
- Do you only need to take creditor interests into account? – ***Ultraframe (UK) Ltd v Fielding*** at [1304]
- Is it a sliding scale?
- ***Carlyle Capital v Conway*** in Guernsey?
- Actual vs potential future insolvency may make a difference.
- The test does remain primarily a subjective one – bona fide in what the directors consider to be the interests of creditors.

Advising your clients

- Ensure adequate financial advice – forecasts and potentially external review
- Minutes of meetings and directors' considerations – long or short?

- What is their liability if directors do not consider creditors' interests when they should?
  - ***Charterbridge v Lloyds [1970] Ch 62***