mourant

UPDATE

On the brink of insolvency: When should directors consider the interests of creditors?

Update prepared by Abel Lyall (Partner, Guernsey)

In the recent decision of *BTI 2014 LLC v Sequana S.A. and others*, the English Court of Appeal issued helpful guidance on the question of when the directors of a company in financial difficulty are obliged to consider the interests of creditors.

Directors of companies in Guernsey owe a common law duty to act in good faith, and in the best interests of the company. In considering the best interests of the company, they are generally required to have regard to what is in the interests of those with a financial stake in the company – normally its shareholders.

It is recognised that where a company is insolvent, directors must have regard to the interests of creditors when deciding what steps are in the best interests of the company. The requirement to consider the interests of creditors may also arise in circumstances short of actual insolvency. But how close to insolvency?

It is a vexing issue for directors, and they have not been assisted by the various articulations of the test by courts, which have included (among others) whether the company is 'bordering on insolvency', 'on the verge of insolvency', of 'doubtful' or 'marginal' insolvency, or at a 'real, as opposed to remote risk' of insolvency.

The most recent and detailed examination of the question in Guernsey came in the decision of the Royal Court in *Carlyle Capital Corporation Limited v Conway & Ors*.[1] The case concerned claims for breach of duty and wrongful trading against the directors of Carlyle Capital Corporation (**CCC**) arising from the failure of the multi-billion dollar fund in 2008. In considering the scope of the duty of directors, the judge found that once it was recognised that the company is 'on the brink of insolvency' the directors' duty to act in the best interests of the company extends to a consideration of the interests of its creditors. The judge went on to hold that this requires giving 'precedence to those interests where that is necessary' and in the particular circumstances of the case to give proper recognition to the fact that the creditors have a priority of interests in the assets of the company over its shareholders if a subsequent winding up takes place. Ultimately the claims in Carlyle did not succeed, with the judge finding the directors of CCC did not act in breach of their duties.[2]

The debate on the issue tends to centre around two main points. First, when does the duty arise? Second, is the obligation to consider creditors 'paramount' or merely another factor that directors must take into account?

In reaching the view expressed in *Carlyle*, the judge referred to a number of English and Commonwealth authorities, including the first instance decision from the English High Court in *BTI 2014 LLC v Sequana*

[1] Guernsey Royal Court, judgment no. 38 of 2017. Mourant Ozannes act for Carlyle Capital Corporation Limited and its joint liquidators.

[2] An appeal of the decision was heard in October 2018 and a judgment is currently awaited.

S.A.[3] This case involved claims against the shareholder and former directors of the company over substantial dividends made while the company was exposed to very large but contingent liabilities. Those claims included a claim for breach of fiduciary duty and for undervalue transactions.

On the question of the interests of creditors, the judge in *Sequana* rejected a submission that directors are not free to take action which puts at real, as opposed to remote, risk the creditors' prospects of being paid first without having considered their interests. This 'real, as opposed to remote' risk test had been adopted in some earlier English decisions and appears less restrictive than other tests using the language of 'verge of insolvency' or 'brink of insolvency'.

In its judgment following an appeal of the decision in *Sequana* handed down last month, the English Court of Appeal also rejected the 'real, as opposed to remote risk' test finding instead that '*the duty arises when the directors know or should have known that the company is, or is likely to become, insolvent*'. The Court also disapproved of articulations of the test that suggest some 'temporal connection' with the ultimate insolvency. Accordingly, suggestions of 'imminent' insolvency or on the 'verge' of insolvency are, the Court felt, inappropriate. Even if the company is able to pay its debts as they fall due for some time, it may be that insolvency is nonetheless likely to occur and decisions taken now may prejudice creditors when the likely insolvency happens.

The Court of Appeal left open the question of whether the interests of creditors should be considered 'paramount' when the obligation to consider those interests arises. While not expressing a view, the Court did go on to say that where a company is in actual insolvency '*it is hard to see that creditors' interests could be anything but paramount*'.

What impact is the decision in *Sequana* likely to have in Guernsey? The view expressed by the English Court of Appeal differs from the one articulated by the Guernsey Court in *Carlyle*. Given the Guernsey Court's adoption of the 'brink of insolvency test' in *Carlyle* rested substantially on an analysis of English authority, in particular the first instance decision in *Sequana*, the latest articulation of the test by the English Court of Appeal should be very persuasive for any Guernsey Court in the future. Absent a definitive view, a director of a Guernsey company should consider whether a company 'is likely to become insolvent' (being that it is more probable than not). As a test it is more readily applicable, and does go some way to assisting directors when considering their obligations in a position of financial stress. If a director forms that view, then they should ensure they have regard to the interests of creditors in their decision making.

It is also important to note that the judge in the *Carlyle* rejected the 'paramount' test, though this now appears to have attracted some support in the Court of Appeal, albeit in circumstances where the company is in actual insolvency. It is too early to tell whether the Guernsey Court's approach of giving 'precedence' where the circumstances of the case require it is the solution ultimately adopted by English Courts when determining whether creditor's interests are in fact paramount. If a director determines that their company is likely to become insolvent, the safest course may be to treat creditors' interests as paramount unless there is some clear reason not to do so.

[3] [2016] EWHC 1686

Contacts

Abel Lyall
Partner, Mourant Ozannes
Guernsey
+44 1481 739 364
abel.lyall@mourant.com