Sequana and the creditor duty: an offshore perspective

Briefing Summary: On 5 October 2022, the UK Supreme Court delivered its judgment in the case of BTI 2014 LLC v Sequana SA & Ors [2022] UKSC 25. This judgment arose from an appeal brought by BTI 2014 LLC against a decision of the English Court of Appeal in 2019.

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The Supreme Court's judgment 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 question of the existence and scope of the so-called "creditor duty", as well as considering 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 in offshore jurisdictions.

The Judgment concerned a decision taken by company directors to approve a distribution to shareholders in circumstances where the company had contingent liabilities arising from long-term environmental obligations, which were uncertain as to their likelihood to arise and as to quantum. The company was solvent when the distribution was lawfully approved by the directors, but several years later the contingent liabilities crystallised, and the company was then deemed insolvent and entered administration. Claims were brought by an assignee of the company against the directors, on the basis that the distribution was made in breach of the "creditor duty", and by one of the company's creditors to set aside the distribution on the basis that it was a transaction at an undervalue.

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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, and decided unanimously that it did (referring to the "*impressive unity of the authorities*" in this area); 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.

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 the 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 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.

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. All of the Justices were clear that the ratification principle could not apply to decisions made at a time when a company is insolvent or which render the company insolvent.

Application 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 Companies Act 2006 expressly recognises the existence at common law of the creditor duty.

We consider below how the reasoning in ***Sequana*** may be applied by the courts in 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 England and Wales, and where English Supreme Court decisions are persuasive, but not binding.

Bermuda

The Bermuda Court held in *Re First Virginia Reinsurance Ltd.* [2003] Bda LR 47 that the directors' statutory duty to act in the best interests of the company under Section 97 of the Companies Act 1981 means, in the context of an insolvent Company, a duty to act in the best interest of creditors. The reasoning of Kawaley J (as he then was) is based on a remarkably similar statutory and common law analysis to that adopted by the UK Supreme Court in the Sequana Case.

In *First Virginia* the Court based the conclusion that directors' duties shift to creditors on the "*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... embodied in section 72 of the [Bermuda] Bankruptcy Act ('Right of bankrupt to surplus') and section 225 as read with section 158 (g) of the [Bermuda] Companies Act*". This principle has been adopted and applied by the Bermuda Courts so frequently since this decision that it is often stated without citation.

Based on the foregoing, the key contribution to Bermuda law that can be derived from the decision in Sequana is the clarification as to when the duty is engaged. It is expected that 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 in paragraphs [203]; [231] will 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 it has been expressly held by the Bermuda Courts to be analogous to administration under English Law.

As for the applicability of the Supreme Court's reasoning in Sequana to the circumstances in which a dividend may become unlawful, the decision is unlikely to have a significant impact since Section 56 of the Companies Act 1981 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) and 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.

British Virgin Islands

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 duty exists under common law likely 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 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 joint venture companies, allowing directors to act in the interests of the shareholder who appointed them.

Perhaps surprisingly, the meaning and scope of these provisions (which have no equivalent in English company law) has never been considered by the courts, but there is potential for tension between these provisions and the creditor duty, which the Supreme Court has now held to be a fiduciary owed to the company. Given the seemingly unambiguous wording of these provisions, allowing directors to act in the interests of a shareholder even where that is not in the interests of the company, there is clearly scope for argument that the creditor duty is qualified in the BVI where these particular provisions apply.

Separately, on the question of how the creditor duty may apply in the context of otherwise lawful distributions by BVI companies, the provisions of the BCA differ from those in the UK, in that the directors of a company can only declare a dividend if, immediately after the payment of the dividend, it can satisfy the statutory solvency test at section 56 of the BCA; the test being whether the company is able to pay its debts as they fall due and the value of its assets is greater than the value of its liabilities. Accordingly, we consider that the creditor duty is 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.

Cayman Islands

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 the *Sequana* case as it relates to the creditor duty.

The *Sequana* judgment will likely have less practical relevance to distributions by Cayman companies. This is because the legal framework for the payment of distribution or dividends to shareholders, which is set out in section 34 of the 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.

Guernsey

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 Carlye 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 duty will be followed in Guernsey.

Further, on shareholder ratification, section 160 of the Companies (Guernsey) Law, 2008 (the "GCL") permits shareholders by passing an ordinary resolution to ratify acts of directors which exceed their powers or amount to negligence, default, breach of duty or breach of trust in relation to the company. However, section 160 also provides that it does not affect any other enactment or rule of law as to the requirements for valid ratification or any rule of law as to acts that are incapable of being ratified by the company. For this reason, common law authorities on shareholder ratification are still relevant in Guernsey. Therefore, the finding in Sequana that shareholders cannot ratify an act or decision of a director taken when the company is insolvent, or which causes the company to become insolvent, is likely to be persuasive in Guernsey.

Finally, where the Sequana judgment is likely to be less relevant in Guernsey is in the context of company dividends. Unlike the position under the UK Companies Act 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 GCL, namely it is able to pay its debts as they become due and the value of its assets is greater than the value of its liabilities.

Jersey

The Companies (Jersey) Law 1991 ("**CJL**") deals with Duties of Directors at Article 74 and requires them to "*act honestly and in good faith with a view to the best interests of the company; and [to] exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances*". The CJL though is not a codifying law so the pre-existing customary law position remains and supplements the CJL. Whilst *West Mercia* has once been mentioned in a Jersey case, that was in a very limited cost hearing context and nothing can be drawn from that one instance. That notwithstanding, the position adopted by most Jersey Advocates would be one where the Creditor Duty was said to exist and our experience is that the Creditor Duty is frequently put to, and accepted by, the Court albeit in the absence of current authority to evidence this. *Sequana* is therefore very useful in reinforcing this point because the Courts in Jersey, in a matter such as this, will regard decisions of the UK Supreme Court as highly persuasive.

The points addressed in *Sequana* on dividends and shareholder ratification are less likely to be as important in Jersey as they will be elsewhere.

As a matter of Jersey law, insolvency is defined as "*the inability to pay your debts as they fall due*". A distribution under the CJL 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.

Shareholder ratification of directors' acts is also possible under CJL 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 (ie if it is not solvent then the ratification fails in any event).

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