Article

October 2022 | Cayman Islands

Directors' Duties on the Precipice of Insolvency: Brief Overview of *BTI 2014 LLC v Sequana SA*

Authors: Jonathon Milne, Partner | **Anna Lin,** Partner | **Spencer Vickers,** Counsel | **Rowana-Kay Campbell,** Associate

The United Kingdom Supreme Court (the "UKSC") recently delivered its eagerly anticipated judgment in *BTI 2014 LLC v Sequana SA and others* [2022 UKSC 25] *("Sequana")*. The reasoning in *Sequana* will be highly persuasive in the Cayman Islands, as well as other common law jurisdictions.

Sequana is a helpful decision for at least the following reasons:

- It confirms the conventional view that the fiduciary duty of directors to act in good faith and in the best interests of the Company applies not only to shareholders but also, where the company is insolvent, is bordering on insolvency or an insolvent liquidation or administration is probable, to act in or consider the interests of creditors (the "creditors' interest duty").
- *Sequana* is the first time the UKSC has adjudicated on the circumstances in which directors must consider the interests of the company's creditors, whether such an obligation can be triggered before the company is insolvent and whether the shareholders can ratify a potential breach of the creditors' interest duty.

Background

Arjo Wiggins Appleton Limited ("AWA") paid dividends in December 2008 (the "December dividends") and May 2009 (the "May dividends") of approximately €578 million to its parent company Sequana SA by way of a set-off against debts owed to Sequana SA. At the time of the respective payments, AWA was solvent, had ceased trading and had one significant contingent indemnity liability for clean-up costs and damages due to the pollution of the Lower Fox River in the United States.

Prior to the dividend payments, AWA's debts included an investment contract and insurance policies collectively worth approximately US$350 million. AWA also had an outstanding debt of €585 million to Sequana SA.

The payment of the dividends was challenged on the grounds that (i) they were paid in violation of part 23 of the UK Companies Act 2006 (the "Companies Act"); (ii) the directors of AWA had breached their duty to have regard to the interest of creditors at the time payments were made; and (iii) the payment of the dividend fell within section 423 of the Companies Act.

AWA initially filed the claim against Sequana SA, but BTI 2014 LLC ("BTI") was substituted as Claimant as AWA had assigned the claims to BTI. BAT Industries plc ("BAT"), the company formed by BTI, filed a separate claim in its capacity as a potential creditor of AWA under section 423 of the Companies Act. Section 423 of the Companies Act contains provisions to protect creditors (actual or potential) from debtors that execute transactions with the aim of putting assets beyond the creditors' reach or otherwise prejudicing the creditors' interest.

First instance decision

Rose J dismissed the December dividends claim, which was not appealed. The learned judge also dismissed the May dividend claim but gave judgment against Sequana SA in relation to the section 423 claim. The learned judge ordered Sequana SA to pay the sum of US$138.4million. Sequana SA filed an appeal in the Court of Appeal. It challenged the findings in relation to the section 423 claim and the dismissal of the claim against the directors that they had breached their duty to consider the interest of the company's creditors.

The Court of Appeal's ("COA") decision

The COA dismissed each of the appeals, except for Sequana SA's cross-appeal on the issue of the interest rate in the section 423 claim. The COA held that, in relation to section 423 of the Companies Act, a dividend is a transaction and the transaction was prejudicial to the creditors. In relation to the creditors' interest duty, the COA affirmed the lower court's decision to reject BTI's claim that the creditors' interest duty is triggered by a "real as opposed to a remote, risk of insolvency." The COA, however, accepted that, in a different case, the said duty may be triggered by circumstances falling short of insolvency.

The UKSC decision

BTI argued in the UKSC that the creditors' interest duty exists where the company is solvent, but there is "a real but not remote risk of its becoming insolvent at some point in the future." BTI submitted that the common law had recognised this duty on directors and that the position was codified by section 172(3) of the Companies Act. The UKSC dismissed BTI's appeal and concluded that the creditors' interest duty is not engaged merely because the company faces "a real and not remote risk of insolvency." The UKSC accepted that it could be engaged where the company is "insolvent or bordering on insolvency."

AWA was solvent, and therefore could not be said to be "insolvent or bordering on insolvency," at the time the dividends were paid. In fact, AWA only became insolvent ten years later. Consequently, the directors were not obliged to consider the interests of AWA's creditors at the material time.

Takeaways

Some key points from the judgment, which are relevant to directors of Cayman Islands companies, are:

- It is now firmly established, at the highest level in the UK, that directors have a duty to have regard to and/or act in accordance with the interests of creditors.
- The general rule is that directors owe fiduciary duties to the company to act in good faith in the interests of the company, which for practical purposes is tantamount to the interests of the shareholders. However, the general rule is modified where "the directors know or ought to know that the company is bordering on insolvency or an insolvent liquidation or administration is probable." This is the point at which the duty to consider the interest of creditors arises.
- Consequently, the creditors' interest duty is subsumed in the fiduciary duties owed by the directors to the company and therefore is not a free-standing duty owed directly to the creditors.
- Directors, in fulfilling their fiduciary duties, are required to engage in a balancing exercise of the shareholders' interest versus the creditors' interest based on the financial position of the company. Therefore, directors should ensure that they are properly informed about the company's financial affairs at all times.
- The creditors' interest duty is justified on the premise that their financial and other interests become paramount as the company enters the zone of insolvency.
- Even if the directors lawfully pay dividends, they are not precluded from liability to the company for breach of the creditors' interest duty and the shareholders cannot ratify the breach of duty.

The decision is highly relevant to the Cayman Islands, particularly in light of recent macro-economic trends and activity. Directors should continue to take care to ensure they comply with their fiduciary duties in all circumstances. This decision reinforces that, where a company's fortunes are descending towards insolvency, directors must ensure that they take into account the interests of the company's creditors and should be encouraged to take independent advice at an early stage.

Authors:

Jonathon Milne
Partner, Cayman Islands
jonathon.milne@conyers.com
+1 345 814 7797

Anna Lin
Partner, Hong Kong
anna.lin@conyers.com
+852 2842 9591

Spencer Vickers
Counsel, Cayman Islands
spencer.vickers@conyers.com
+1 345 814 7757

Rowana-Kay Campbell
Associate, Cayman Islands
rowana-kay.campbell@conyers.com
+1 345 814 7366

This article is not intended to be a substitute for legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and give general information.

For further information please contact: media@conyers.com