UPDATE

SEPTEMBER 2024

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'Insolvency deepening' activity – Risk for Cayman Islands Directors

Update prepared by Peter Hayden (Cayman Islands).

The recent English High Court decision of ***Wright v Chappell*** related to the collapse of British Home Stores provides a landmark ruling of which directors of Cayman Islands companies need to be aware. This is the first time damages have been awarded against directors for 'misfeasant trading'. Directors may be held liable for any 'insolvency deepening' activity in failing to file for insolvency when it would be in the creditors' interests to do so.

Introduction

- Unlike England, the Cayman Islands has not introduced any statutory provisions relating to wrongful trading that could impose liability on directors for allowing a company to continue to trade when they knew, or should have known, that it had no realistic prospect of recovery.
- However, a recent decision in England has indicated that directors may be liable under the common law for breach of duty in these circumstances.
- This is an important development of which all Cayman Islands directors should be aware.

Background

This development arises from a decision of Mr Justice Leech dated 11 June 2024 in litigation related to the collapse of British Homes Stores (*Wright & Ors v Chappell & Ors (Re BHS Group Ltd & Ors (in liquidation)* (***Wright v Chappell***)). For the first time, damages were awarded against directors for 'misfeasant trading'. Although the relevant directors' duties in England are codified in the English Companies Act, they derive from common law duties that also exist in the Cayman Islands. The decision means that directors may be held liable for 'insolvency deepening' activities in failing to file for insolvency when it is in creditors' interests to do so.

Duty to have regard to the interests of creditors

It is well known that directors generally owe their duties to the company, which is regarded as the body of shareholders as a whole, rather than to individual shareholders.

In 2019 the UK Supreme Court held in *BTI v Sequana* that directors must in certain circumstances also have regard to the interests of creditors. Although the creditor duty in that case arose under section 172(3) of the English Companies Act, the Supreme Court unanimously found that section 172(3) preserved the common law rule recognised in an earlier 1988 English Court of Appeal decision, *West Mercia Safetywear Ltd v Dodds*.

The Supreme Court said that the creditor duty is a duty to consider creditors' interests, to give them appropriate weight, and to balance them against shareholders' interests where they may conflict. The duty was variously said to arise where insolvency was imminent, where the company was insolvent or bordering on insolvency or where an insolvent liquidation or administration was probable. It followed that an 'insolvency deepening' activity can amount to a breach of duty by directors even though insolvent liquidation is not inevitable and where there is no liability for wrongful trading.

Misfeasance by directors

In *Wright v Chappell*, the directors were found to be liable for 'misfeasant trading', in that they acted for an improper purpose and breached their duty to have regard to the interests of creditors. The quantum of the liability remains to be determined but could be up to £133.5 million, representing the increase in the net deficiency of the company's assets arising during the relevant period.

Although acting for an improper purpose is a different duty to having regard to the interests of creditors, the rule that directors must act for a proper purpose also arises out of the common law and applies in the Cayman Islands.

In *Wright v Chappell*, the directors sought to rely heavily on advice they had sought from legal and accountancy advisers. However, the judge said that the weight to be attached to professional advice would depend on a number of matters, including:

- the scope of the engagement;
- the instructions given to the advisers;
- the knowledge of the advisers and the assumptions that they were asked to make; and
- the advice which they gave and the extent to which the directors relied on the advice given.

Therefore, it is important for directors to ensure that they seek appropriate advice, properly brief their advisers and act on the advice if they wish to rely on that professional advice as a defence to a claim.

Conclusion

The absence of a statutory wrongful trading provision in the Cayman Islands Companies Act does not mean that directors cannot be liable for continuing to trade when there is a risk of insolvency and of their activities prejudicing creditors. Where there is such a risk, it is important for directors to obtain proper professional advice, act on that advice, ensure due consideration is given to the interests of creditors and carefully consider whether the company should be placed into liquidation rather than continuing to trade.

Directors need to exercise particular care in allowing the company to continue to trade in these circumstances. This is not least because failing to consider matters properly may prevent directors from relying on any indemnities in their favour contained in the company's constitutional documents, and the potential liabilities may considerably exceed the amount of any directors and officers' (D&O) insurance in place.

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