Article

COVID-19: Directors Need To Avoid Getting Caught Flat-Footed

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This article serves as a reminder to directors of their common law duties. In particular when a company is nearing or in the zone of insolvency, directors are reminded to be mindful of their actions during this period, specifically to consider that when a company is nearing insolvency, the interest of the company becomes synonymous with the interests of its creditors.

Introduction

In what seems the blink of an eye, the world around us has changed beyond recognition. On 11 March, 2020 the World Health Organisation officially declared COVID-19 a pandemic. The ramifications of COVID-19 are being experienced worldwide. Businesses are facing tough decisions in every industry with respect to how to manage the virus and caught in a difficult conundrum of ensuring that they are making responsible decisions while striving to maintain a level of corporate profitability. While it may take months or possibly years before the full economic effects of COVID-19 are fully realised, directors will have difficult questions to face in terms of the immediate actions that will need to be taken in an effort to secure the future of businesses. In these challenging and unsettling times directors must remain mindful of ensuring they continue to comply with their common law fiduciary and statutory duties and in particular, considerations that may impact a business as a result of COVID-19. Directors must ensure that they are not caught flat-footed and take proactive steps to protect companies and more importantly its creditors.

Directors' duties in the context of COVID-19

A director plays a critical role in the affairs of a company. A director's action or inaction will impact a company's fortunes and those of its shareholders, employees and creditors. Cayman Islands law is largely derived from English common law principles and statutesand the Cayman Islands' courts regard English authorities as persuasive. Unlike England, in the Cayman Islands, the general duties of directors are not codified. In addition to the general duties derived from the common law, certain duties are to be found in Cayman Islands statutes, principally the Companies Law. Directors' duties may also be confined by the company's constitutional documents, namely its articles of association.

At common law, a director owes two types of duties to the company; fiduciary (which are unlimited) and duties of skill, care and diligence. As businesses begin to feel the impact of COVID-19 it is important that directors exercise caution in their actions, as if a company does fail, those very actions (or inactions) could come under a liquidator's scrutiny or disgruntled creditor attacks.

Fiduciary Duties

Individual directors have a fiduciary duty to observe a general standard of loyalty, good faith and the avoidance of a conflict of duty or self-interest. In brief, directors have a duty to act in good faith in the best interests of the company. This includes:

- a duty to exercise powers in the company's interest (and not for an improper purpose)
- a duty to remain independent and not to fetter discretion
- a duty not to make a secret profit
- a duty to avoid actual or potential conflicts of interest

Duty of skill, care and diligence

A duty of skill, care and diligence is different under English and Cayman Law to a fiduciary duty. The essence of a fiduciary duty is honestly and fidelity, whilst the duty of care and skill is focused more on the overall competency of a director. The duty of care and skill comprises both subjective and objective elements.

The subjective element was described in the case of *Re Brazilian Rubber Plantations and Estates* Ltd [1911] 1 CH 425:

> *"Such reasonable case must, I think, be measured by the care an ordinary man might be expected to take in*

> *the same circumstances on his own behalf. He is clearly, I think, not responsible for damages occasioned by error of judgment".*

The objective element requires a director to act with the skill, care and diligence (competency) that might reasonably be expected of someone carrying out that particular role at that particular time.

In practice, this means that directors must ensure that they maintain a sufficient knowledge and understanding of the company's business and that they are proactive in their role at this critical time for the business to ensure that the actions they do take are objectively and subjectively believed to be in the best interests of the company at the time they are taken.

To whom are the duties owed?

It is an important time for directors to understand to whom their duties are owed. Simply put, provided that the company is solvent, directors' duties are owed to the company itself (i.e. to the shareholders collectively). Directors' duties to company employees are incorporated in their duties to the company and require directors to operate lawfully in relation to an employee's rights.

Directors do not owe a duty to creditors while the company is solvent. However, such a duty arises if the company is insolvent or near insolvency. When a company is nearing insolvency, the interests of the company become synonymous with the interests of its creditors. In other words, in such circumstances the interests of the shareholders are subordinated to the interests of the creditors and the directors have a duty to shift their focus to ensuring that any decision made is not necessarily in the company's interest but must be in the interest of the creditors' (as a general body).

Zone of insolvency – the pendulum swings

The reasoning behind the principle was explained in the following terms by Street CJ in *Kinsela v. Russell Kinsela Property Ltd* [1986] 4 NSWLR 722, 730:

> *'In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration*.'

Dillon LJ in *Liquidator of West Mercia Safety Wear Ltd v. Dodd & Anor* [1988] 4 BCC 30 cited with approval the above *Kinsela* passage. In *West Mercia*, it confirmed that directors owe a duty to take into account the interests of creditors in circumstances where the company, and the group to which it was a member, were in a *"very dangerous"* or *"parlous"* financial position such that the future of the group probably depended on satisfactory refinancing arrangements becoming available. This position was re-enforced in the recent English Court of Appeal decisions of *BTI 2014 LLC v. Sequana SA [2019] EWCA Civ 112*. Interestingly, in the *Sequana* case the judge found that something short of actual insolvency (cash flow or balance sheet test) would also trigger the duty, as opposed to a duty that arises when a company is actually insolvent. In this regard, duty was said to arise when a director knew or should know that the company is or is likely to become insolvent.

Harre J in the Grand Court of the Cayman Islands recognised the duty to take account of creditors' interests when nearing or in the zone of insolvency, in the decision of *Prospect Properties Limited (In Liquidation) v. McNeill & Anor* [1990-91] CILR 171. Although there has not been a recent decision on this in Cayman, it is likely that the Grand Court will follow the English decision, in particular the detailed judgment provided in this area in *Sequana*.

Corporate restructuring - advice for directors

The duty to act in the interests of creditors might include considering corporate restructuring options, such as whether the company should be placed in provisional liquidation or put in place a scheme of arrangement.

Schemes of arrangement are effective tools for corporate restructuring. Cayman law allows a company to enter into a debt restructuring arrangement that is passed by a special majority (75%) and simple majority by number of the company's creditors. Without coupling a scheme of arrangement with an application to appoint provisional liquidators, a company will not, however, benefit from any moratorium on claims against it. Once the company is placed into provisional liquidation, an insolvency practitioner will be appointed and creditors (other than secured creditors) will be prevented from taking any debt enforcement steps during this period.

A more draconian option would be to put the company into compulsory liquidation. This usually occurs where the company has no chance of survival, or where there is a complete loss of substratum and no visible lifeline for going forward.

Before any of the above options are considered, there are simple practical steps that directors can take immediately. Provided that directors seek professional advice early, communicate clearly with the company's creditors and can rationalise continuity decisions as being in the best interest of those impacted (whether that is the company or its creditors) it is possible to keep a company continuing as a going concern. Clear and consistent communication with creditors can prevent hostile attacks by way of creditor petitions to wind up the company while directors are formulating their corporate restructuring options. Frequent assessments of a company's cash flow and balance sheets and updates to creditors are vital during this period.

Directors will need to make difficult and relatively speedy decisions on areas where costs can be cut and consider alternative funding sources to assist a company in staying afloat and to keep creditors on side during this time.

Conclusion

While directors owe fiduciary duties and obligations to the company and not to individual shareholders, it is worth remembering that directors must act in a way to promote the success of the company. In addition, a director must act reasonably in light of the factual circumstances at the time, which currently include the existence of the COVID-19 pandemic. Therefore, if directors were completely reckless or blind as to the potential impact of COVID-19 and the balance sheets/cash flow of a company, there could be a risk of liability, in particular if they fail to heed their legal obligations to their creditors when a company nears (as per the *Sequana* decision) or enters the zone of insolvency. With the right approach, the hostility of creditors can be managed and often avoided. In addition, with the right legal support the most appropriate corporate restructuring option can be chosen and course of action tailored to fit the needs of the company.

For more information on directors' duties during the zone of insolvency or on the corporate restructuring options available in the Cayman Islands please reach out to your usual Conyers contact, or one of those listed below.

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