Contingent liabilities: A Director's responsibility?

In a previous article titled, *contingent liabilities points for the Cayman Islands voluntary liquidator to consider*, Grant Thornton explored the challenges and risk of contingent liabilities from a liquidator's perspective. Directors also face similar challenges and risks when preparing to place a company into voluntary liquidation.

In the Cayman Islands, all directors must swear a Declaration of Solvency (DofS) in a voluntary liquidation

In a Cayman Islands voluntary liquidation, a DofS is required to be sworn by each person who was a director of the company on the date on which its voluntary winding up was commenced (Companies Winding Up Rules, 2018 (CWR) O.14, R1(1)). A DofS means a declaration or affidavit in the prescribed form (CWR Form No. 21) to the effect that a full enquiry into the company's affairs has been made and that to the best of the directors' knowledge and belief the company will be able to pay its debts in full together with interest at the prescribed rate, within such period, not exceeding twelve months from the commencement of the winding up, as may be specified in the declaration (sec. 124(2) Cayman Islands Companies Law (2018 Revision)) ("Cayman law").

The identification of or existence of contingent liabilities at the time of swearing a DofS is particularly important where directors conduct pre-liquidation distributions and hand over the shell of the company to a liquidator for a statutory winding up, or where the directors themselves conduct the voluntary winding up (which is permissible under Cayman statute).

Contingent liabilities pose a risk and potentially serious consequences for its directors in terms of liability and breach of duty if missed and later crystallise, particularly in circumstances where the Directors are signing a DofS.

A person who knowingly makes a DofS without having reasonable grounds commits an offence under Cayman law (sec. 124(3)). The reference to due enquiry will clearly leave the directors in a difficult position <u>if reasonably ascertainable contingent liabilities</u> crystallise and cannot be settled.

On the other hand, if the directors fail to swear a DofS within 28 days of the commencement of the voluntary liquidation, the liquidators will be obliged to apply to the Cayman court for an order that the liquidation continue under the supervision of the court (sec. 124(1)), a process which will prove more costly and take longer.

The challenge: determining ability to pay debts within 12 months

A company's balance sheet reflects assets available to settle its liabilities. In a typical business operation, *ceteris paribus*, a company would normally settle liabilities as and when they become due: current liabilities within 12 months and long-term liabilities thereafter. The sec. 124 test however requires directors to swear that the company will be able to pay its debts <u>in full</u> (i.e. both current and long-term liabilities) within 12 months.

While a company may be cash flow solvent and therefore able to pay its debts as they fall due, including those that will become due after the 12 months, it may not necessarily be able to pay all debts within 12 months if assets are not immediately realisable or sufficiently liquid to facilitate such short-term pay-out. A long-term commitment that prematurely becomes a short-term obligation could pose a challenge for a company that is otherwise financially stable. A company that has sufficient assets to pay liabilities and therefore balance sheet solvent could in fact suffer from short-term liquidity problems.

However, taking into account, *inter-alia*, liquidity and timing factors under the particular circumstances of a company, it is not impossible to make a determination as to a company's ability to pay its quantifiable debts in full from quantifiable assets, particularly if the business has been significantly wound down at the point of swearing the DofS.

The challenge for a director of the company is making such a determination where contingent liabilities are involved and where there is no prospect of crystallisation within 12 months or no immediate indication of quantum to be crystallised within 12 months.

Contingent liabilities by their very nature are uncertain, and not immediately payable. A contingent liability is a possible obligation depending on whether some uncertain future event occurs; or a present obligation but payment is not probable, or the amount cannot be measured reliably (IAS 37.10). For example:

I. pending or threatened litigation
II. actual or possible claims and assessments
III. indemnities, guarantees and warranties
IV. certain tax liabilities
(FASB Accounting Standards Codification ASC 450—20-05-10)

Contingent liabilities may or may not be accrued or disclosed in a company's financial statements depending on the accounting principles applied (i.e. US GAAP vs IFRS). As such, directors should be careful to rely solely on financial statements when swearing a DofS. Similarly, directors who did not consider liabilities sufficiently probable to accrue or disclose in the financial statements, might not think to consider them when swearing a DofS when in fact, they ought to be considered.

Directors' liability for invalid DofS

A recent judgment of the English High Court, *LRH Services Limited (in liquidation) v Trew and others* [2018] EWHC 600(Ch) ("*LRH Services Limited*") has highlighted the potential risk for directors in making a DofS about a company without having made a full inquiry into its affairs. The case provides an instructive reminder for directors that the consequences can be severe if directors are not extremely diligent when reviewing a company's financial information prior to forming an opinion that a company is solvent. The judgment confirmed the position set out in *BTI 2014 LLC v Sequana* [2016] EWHC 1686 (Ch) that a DofS will be valid so long as the director honestly and genuinely formed the required opinion, even if the director did not have reasonable grounds for holding it.

In *LRH Services Limited,* the liquidator brought an action against three former directors in connection with a reorganisation of the group of companies which involved a reduction of share capital pursuant to s.643 of the UK Companies Act 2006. The reorganisation resulted in a £21 million dividend being paid to the parent company after the company went into liquidation. In order to avail of the s.643 procedure, a solvency statement was made by the directors of LRH. Similar to the Cayman DofS, in England this involves a statement that each of the directors of the company have formed the opinion that there is no ground on which the company could be found to be unable to pay its debt on the date of the statement and also the opinion that the company will be in a position to pay its debt for the following 12 months. It was held in this case that the solvency statement made by the directors was invalidly made on the basis that the opinion of solvency had not been properly formed. The court found that the directors had failed to make any enquiries or consideration to the company's actual liabilities as required by statute. It transpired that one of the company's directors was relying on the parent company of LRH to meet the company's debt, (despite there being no binding agreement to this effect), in order to support the opinion that the company was solvent. The court held that in consequence, the capital reduction made on the basis of the DofS was therefore unlawful and that each director was personally liable to the company for the £21 million dividends paid out as a result of the reorganisation.

This judgment, which would be persuasive authority in the Cayman Islands, highlights important considerations for directors when forming an opinion as to the solvency of a company to take into account all the company's liabilities, including any contingent or prospective liabilities. Failing to do so, they could find themselves being held personally liable for the debts of the company.

Conclusion

Therefore, before swearing a DofS on the premise of his best knowledge and belief, a director may need to seek professional and legal advice in appropriately evaluating the circumstances of his particular case when contingent liabilities are involved.

Contingent liabilities are relevant to the liquidator upon appointment both from understanding the company's financial position as well as the requirement to notify all creditors, including contingent creditors, of the liquidation. Whilst there is no formal proving process in a Cayman Islands voluntary liquidation, a contingent creditor who successfully "proves" his claim in the liquidation will be entitled to participate in any share of the company's assets.

Any claim that so impacts the solvency of the company that the company becomes or is likely to become insolvent, the liquidator has a statutory obligation to make a court application (sec. 131) for the continuation of the winding up under the supervision of the Cayman court. This results in significant costs and a change to the liquidation procedure completely.

For a director, seeking input from professional and legal advisors such as Insolvency Practitioners and lawyers may provide ways to deal with contingent liabilities either pre-liquidation or upon liquidation of the company, depending on the circumstances of your particular case, that could, among other things:

- Crystallise them;
- Extinguish them;
- Avoid them entirely; or
- Identify alternative options available to the company including assignment, risk management, possible schemes of arrangement, court direction, etc.

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