Litigation Alert

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Priorities in the Twilight Zone—UK Supreme Court Considers the Point at Which Directors Must Consider the Interests of Creditors as Insolvency Approaches

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BTI 2014 LLC (Appellant) v Sequana SA and Others (Respondents)

Summary

The UK Supreme Court has, for the first time, considered the existence, content and engagement of an obligation on directors to take into account the interests of creditors when a company becomes, or is on the cusp of becoming, insolvent (otherwise known as the "creditor duty").

In its long-awaited judgment, handed down on 5 October, the Supreme Court held that when directors know, or ought to know, that a company is insolvent or bordering on insolvency, or that an insolvent liquidation or administration is probable, their duty to consider the interests of creditors is triggered.

We set out below the background to the case and the key points of this aspect of the Supreme Court's decision.

Background

AWA, a wholly owned subsidiary of Sequana, had ceased trading by December 2008. At that time, its only liability was a contingent liability in the form of an indemnity for an uncertain amount, for which the directors of AWA made a provision of €62.8 million.

AWA's assets consisted of an investment contract capped at $250 million, historic insurance policies with expected recoveries of an uncertain amount and a debt of €585 million owed by Sequana to AWA.

In May 2009, AWA's directors paid a dividend of €135 million to Sequana (the "May dividend"), which (along with a prior dividend in December 2008) reduced by way of set-off the debt owed by Sequana to AWA from €585 million to about €3.1 million.

The May dividend was distributed at a time when AWA was both balance sheet and cash flow solvent, and it was agreed by the parties that the May dividend itself was

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lawful because it complied with the statutory scheme regulating the payment of dividends and common law regarding maintenance of capital.

Because of the uncertainty as to the amount of AWA's liabilities and assets, there was at the time of the May dividend, as the Supreme Court puts it, "a real risk, although not a probability, that AWA might become insolvent at an uncertain but not imminent date in the future".

In fact, AWA went into insolvent administration in October 2018. BTI – a vehicle set up by a creditor of AWA and to which AWA's claim against its directors was assigned (prior to, but maintained in, AWA's insolvency) – sought to recover the amount of the May dividend from AWA's directors on the basis that their decision to make the May dividend was a breach of their duty to act in the best interests of creditors.

Although the claim had a number of elements, the key issue that came before the Commercial Court was the question of whether – and if so, when – the directors' duty to act in the interests of the company's members (i.e. shareholders) is superseded by a duty to act in the interests of its creditors as the company nears insolvency. The judge at first instance dismissed BTI's claim, finding that the risk of insolvency at the relevant time was not sufficient to trigger an obligation to creditors.

The 2019 Court of Appeal Decision

The case reached the Court of Appeal, and judgment was handed down in February 2019.

The Court of Appeal rejected BTI's argument that the creditor duty arises where a proposal involves a "real, as opposed to a remote, risk to creditors" and took the view that the test of a real, as opposed to a remote, risk of insolvency was too low a threshold to be the legal test. It also clarified that the risk of insolvency at some point in the future was insufficient unless it amounted to a probability. BTI's claim was dismissed.

The Court of Appeal concluded that "the duty arises when the directors know or should know that the company is or is likely to become insolvent" and clarified that "in this context, "likely" means probable".

BTI appealed the decision to the Supreme Court.

The Supreme Court Decision

The Supreme Court also dismissed BTI's appeal, agreeing unanimously that the creditor duty was not engaged at the time when the May dividend was paid. In doing so, the Supreme Court considered and elaborated on a number of key legal points.

1. In response to a challenge brought by the respondents, it affirmed the existence of the creditor duty, confirming that the duty on directors to act in a manner which they consider, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole (under section 172(1) of the Companies Act 2006) is, in certain circumstances, modified by the common law rule that the company's interests are taken to include the interests of the company's creditors as a whole (a position which, as Lord Briggs noted, is reflected in section 172(3) of the Companies Act 2006).

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2. It considered *when* the creditor duty arises. By majority, the Supreme Court held that:

> (a) an imminent insolvency (i.e. an insolvency which directors know or ought to know is just round the corner and going to happen); or
>
> (b) the probability of an insolvent liquidation (or administration) about which the directors know or ought to know,

was in each case a sufficient trigger for the engagement of the creditor duty.

Lord Briggs, giving the majority judgment, went on to clarify that “[I]t will not be in every or even most cases when directors know or ought to know of a probability of an insolvent liquidation, earlier than when the company is already insolvent. But that additional probability-based trigger [i.e. limb (b) above] may be needed in cases where the probabilities about what lies at the end of the tunnel are there for directors to see even before the tunnel of insolvency is entered”.

In reaching this conclusion, the Supreme Court adjusted the point at which the creditor duty is engaged – away from the point of time at which insolvency is merely “probable” (the Court of Appeal’s position) to a point of time at which insolvency is imminent or an actual insolvent administration or liquidation is probable.

3. However, whilst Lord Reed and Lady Arden agreed in most part with the majority, they left open the question as to whether the directors’ knowledge was an essential part of either trigger, potentially exposing the necessity of such knowledge to further judicial consideration.

4. The Supreme Court also concluded that the duty to have regard to the interests of members and/or creditors are not different or independent duties. In both cases, the duty in question is the directors’ fiduciary duty to act in good faith in the interests of the company, as codified by the Companies Act 2006. The ordinary rule in respect of that duty is that the company’s interests are taken to be equivalent to the interests of its members as a whole. The “creditor duty” is merely a modifying rule, such that when it applies, the company’s interests are taken to include the interests of its creditors as a whole.

5. By extension, the balance between member and creditor is something of a sliding scale. Accordingly, the effect of the creditor duty is, as Lord Reed put it, “to require the directors to consider the interests of creditors along with those of members. The weight to be given to their interests, insofar as they may conflict with those of the members, will increase as the company’s financial problems become increasingly serious. Where insolvent liquidation or administration is inevitable, the interests of the members cease to bear any weight, and the rule consequently requires the company’s interests to be treated as equivalent to the interests of its creditors as a whole”.

6. And, when considering the interests of creditors, the directors must consider creditors as “the general body of creditors” and not make distinctions between their respective claims or positions of seniority.

Implications of the Supreme Court’s Decision

Directors in England have long been aware of their duty to consider the interests of creditors as a company enters or nears insolvency and the risk of personal liability if

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they get it wrong. In that context, the Supreme Court's affirmation of the *existence* of the "creditor duty", while helpful, is not as significant as the (hopefully) clearer and more practical guidance on when the creditor duty is engaged.

The English court has demonstrated its awareness that, in some cases, the prospect of insolvency can be temporary and, with its conclusion that the creditor duty is only triggered at a later point in time (when insolvency is actual or imminent (rather than when there is simply a real risk of insolvency)), directors might now feel less constrained when operating close to the zone of insolvency. That said, each situation will turn on its facts and, even with this judicial clarification, prudent directors may still struggle to determine if and when the creditor duty has been triggered and may end up exercising as much caution in such circumstances as they would have done prior to the *Sequana* judgment.

The judgment also serves as a reminder that there may be times when, despite the prospect of a threatened or actual insolvency and the engagement of the creditor duty, both creditors and members have "skin in the game". If in those (possibly less common) circumstances there is a conflict between the interests of each group, directors may have the potentially unwelcome and difficult task of assessing the levels of weight that should be given to their respective interests.

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