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Sequana: UK Supreme Court Provides Useful Guidance for Directors of Financially Distressed Companies on the Existence of Creditor Duty and When It Arises

by Anna Nolan

On 5 October 2022, in the matter of *BTI 2014 LLC v Sequana SA* and others ([2022] UKSC 25), the UK Supreme Court considered directors' creditor duty when the company is in the zone of insolvency. Creditor duty is the duty of a company's directors to consider, or to act in accordance with, the interests of the company's creditors when the company becomes insolvent or when it approaches, or is at real risk of, insolvency. The creditor duty is also known as the 'rule in West Mercia' after the leading case of *West Mercia Safetywear v Dodd*. The *Sequana* judgment addresses questions of considerable importance for directors of financially distressed companies, especially in the current business environment.

Background to the Appeal

In May 2009, the directors of AWA caused it to distribute a dividend of €135 million to its only shareholder, Sequana SA. This extinguished almost the whole of a larger debt which Sequana owed to AWA. The May dividend complied with the statutory scheme regulating the payment of dividends and with the common-law rules on the maintenance of capital. At the time the May dividend was paid, AWA was solvent on both a balance sheet and a cash-flow basis. However, it had long-term pollution-related contingent liabilities of an uncertain amount and an insurance portfolio of an uncertain value. There was a real risk that AWA might become insolvent in the future, though insolvency was not imminent, or even probable.

AWA went into insolvent administration in October 2018. The appellant, BTI 2014 LLC, sought to recover the amount of the May dividend from AWA's directors, arguing that the directors' decision to distribute the May dividend was taken in breach of the creditor duty because the directors had not considered or acted in the interests of AWA's creditors.

Both the High Court and the Court of Appeal rejected the creditor duty claim. In the judgment of the Court of Appeal, the creditor duty did not arise until a company was either actually insolvent, on the brink of insolvency, or probably headed for insolvency. Its provisional view was that the creditor duty became paramount as soon as the company became insolvent. Since AWA was not insolvent or on the brink of insolvency in May 2009, BTI's creditor duty claim failed, and BTI appealed to the Supreme Court.

Was the Creditor Duty Engaged on the Facts of This Case?

The Supreme Court unanimously dismissed BTI's appeal and held that the creditor duty was not engaged on the facts of this case. This is because, at the time of the May dividend, AWA was not actually or imminently insolvent, nor was insolvency even probable.

Key Takeaways from the Supreme Court Judgment

Does a common-law creditor duty exist under English law?

Section 172(1) of the 2006 Companies Act requires directors to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. The Supreme Court held that, in certain circumstances, this duty is 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.

The Supreme Court ruled that the creditor duty should be affirmed because:

- The duty is supported by a long line of UK case law (as well as authority from Australia and New Zealand), which began in the mid-1980s.
- The duty is affirmed, or its possible existence is preserved, under Section 172(1) of the 2006 Companies Act 'subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company'.
- The duty has a coherent and principled justification – creditors always have an economic interest in the company's assets, but the relative importance of that economic interest increases when the company is insolvent or nearing insolvency.

The shareholder authorisation or ratification principle does not prevent the recognition of the creditor duty. When the directors are under a duty to act in good faith in the interests of the creditors, the shareholders cannot authorise or ratify a transaction which is in breach of that duty because there can be no shareholder ratification of a transaction entered into when the company is insolvent, or which would render the company insolvent.

The Supreme Court ruled that the creditor duty is not a free-standing duty that is owed to creditors because directors owe their duties to the company, rather than directly to shareholders or to creditors.

Can the creditor duty apply to a decision by directors to pay an otherwise lawful dividend?

The Supreme Court held that the creditor duty can apply to a decision by directors to pay a dividend which is otherwise lawful, for two reasons:

- Part 23 of the 2006 Companies Act is subject to any rule of law to the contrary. Since the creditor duty is part of the common law and is recognised by Section 172(3) of the 2006 Companies Act, it is not excluded by Part 23.
- A decision to pay a dividend that is lawful under Part 23 may still be taken in breach of duty. Part 23 identifies profits available for distribution on a balance sheet basis, but it cannot be the case that directors of a company which is cash flow insolvent (i.e. unable to pay its debts as they fall due) could lawfully distribute a dividend.

The creditor duty applies when directors are considering the payment of a dividend, even if the accounts demonstrate sufficient distributable reserves.

Content of the creditor duty

If the company is insolvent, or bordering on insolvency, but is not faced with an inevitable insolvent liquidation or administration, the directors should consider the interests of creditors, balancing them against the interests of shareholders where they may conflict. The greater the company's financial difficulties, the more the directors should prioritise the interests of creditors.

The interests of creditors are the interests of creditors as a general body. The directors are not required to consider the interests of particular creditors in a special position.

The Supreme Court stated that the content of the rule in *West Mercia* is not limited to consideration of creditors' interests; the directors are also required not to harm those interests (and this protects creditors against 'insolvency-deepening' activity of the directors). The progress towards insolvency may not be linear; therefore, directors should stay informed of the company's financial position. The Supreme Court stated that at a certain point in time, the interests of creditors will have to have priority over any other interest. The Supreme Court held 'that point in time is not reached until the company becomes irreversibly insolvent and must enter liquidation or some formal insolvency procedure, most importantly a "rescue" procedure … Directors cannot have "two masters". However, if a company becomes irreversibly insolvent, directors must disregard the interests of shareholders if they conflict with those of creditors.… The meaning of "insolvency" must be contextual and appropriate to the Rule in *West Mercia*.'

The Supreme Court held that when an insolvent liquidation or administration is inevitable, the creditors' interests become paramount because the shareholders cease to retain any valuable interest in the company. In Lord Briggs's judgment, this happens at the point that Section 214 of the 1986 Insolvency Act also becomes engaged.

Engagement of the creditor duty

The Supreme Court ruled that the creditor duty is engaged when the directors know, or ought to know, that the company is insolvent or bordering on insolvency, or that an insolvent liquidation or administration is probable. Consequently, this is the settled legal position for now; however, Lord Reed and Lady Arden left open the question of whether it is essential that the directors know or ought to know that this is the case. As a result, the issue of whether the directors' knowledge of insolvency is required may be open for further judicial consideration.

Conclusion

The Supreme Court has affirmed the existence of the creditor duty and provided some guidance on the content of such a duty and when it is engaged. The Supreme Court found that it is not enough that insolvency itself is likely (or probable) before the duty is engaged. The company must be insolvent or bordering on insolvency, or an insolvent liquidation or administration must be probable. The decision acknowledges that facing a real risk of insolvency is common for many companies and may be temporary.

Directors of financially distressed companies must have regard to creditors' interests from the point the company is bordering on insolvency (but not merely because the company is at a real risk of insolvency at some point in the future). From that point, shareholders cannot authorise or ratify a director's breach of the creditor duty because there can be no shareholder ratification of a transaction entered into when the company is insolvent or which would render the company insolvent.

The engagement and content of the creditor duty remains an area that must be carefully considered by directors of UK companies and their advisors, especially in cases involving trading companies facing pressures associated with the current market volatility, inflation, and increased interest rates environment or companies with complex capital structures whose matrix of creditor arrangements and liabilities may be more complicated.

Finally, the Supreme Court judgment does not provide answers to every relevant question when considering the creditor duty. For instance, the consequence of a breach of the duty and the forms of relief available remain an area where further developments are expected.

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