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UK Supreme Court Confirms Existence of Directors' Duties to Creditors

In *BTI 2014 LLC v. Sequana S.A.* [2022] UKSC 25 (Sequana) the UK's highest court, the Supreme Court (the Court), has considered for the first time the circumstances in which directors are required to consider the interests of creditors in carrying out their fiduciary duty to act in good faith in the interests of the company.

The Court confirmed that when a company is insolvent or bordering on insolvency, or when an insolvent liquidation or insolvent administration is probable, this fiduciary duty is modified by common law such that the company's interests are taken to include the interests of its creditors as a whole (the Creditor Duty).

The Court confirmed that imminent insolvency, or a probability of an insolvent liquidation or insolvent administration, are the trigger points for directors to consider the interests of creditors.

The Court rejected the "real risk of insolvency" as the appropriate trigger for engagement of the Creditor Duty.

The decision provides some clarity to directors of distressed companies, as well as insolvency practitioners investigating the conduct of directors.

Facts

- In 2009, the directors of Arjo Wiggins Appleton Limited (AWA) declared a dividend of €135 million to Sequana SA, being its only shareholder.
- The dividend was lawful, as it was paid out of distributable profits and, at the time of distributing the dividend (by way of set-off, as Sequana then owed money to AWA), AWA was, as an accounting matter, both balance-sheet and cash-flow solvent.
- However, AWA had at the time of the dividend contingent environmental liabilities of an uncertain amount and assets of an uncertain value. This gave rise to a real (although not probable) risk that AWA might become insolvent in the future.
- Nine years after the dividend, AWA entered insolvent administration whereby all creditors were not paid in full.
- Following decisions of lower courts, the Court was asked to consider whether the directors of AWA were in breach of their fiduciary duty in causing AWA to declare and distribute the dividend and failing to consider the interests of creditors at the time.

Existence of a common law duty to creditors

Section 172(1) of the Companies Act 2006 (the Companies Act) provides that a director of a company must act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so the director must have regard to a non-exhaustive list of certain matters (the interest of creditors generally is not mentioned in that list).

However, under section 172(3) of the Companies Act, this duty is 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. In *Sequana*, the Court determined that such a rule of law did indeed exist, being the Creditor Duty, and went on to consider its scope and application.

Content of the Creditor Duty and when it is engaged

In four separate written judgements (itself an unusual occurrence in the Supreme Court), the following observations were made by members of the Court about the content of the Creditor Duty and when it is engaged:

- Importantly, the Court unanimously held that the Creditor Duty is **not** engaged simply because there is a 'real and not remote' risk of insolvency at some point in the future (as was the case on the facts in *Sequana*), where that risk is not imminent.
- When the Creditor Duty is engaged, the directors need to take into account the interests of the company's creditors. This will necessarily involve a balancing exercise by the directors and giving appropriate weight to the interests of creditors where they conflict with the interests of the shareholders.
- Where the company is actually insolvent (i.e., cash-flow or balance-sheet insolvent) or bordering on insolvency (i.e., where insolvency is 'probable') but is not currently facing an inevitable insolvency procedure such as liquidation or administration, the directors' fiduciary duty to act in the company's interests has to recognise that both the shareholders and the creditors may have an interest in the company's affairs.

- In this situation, there is conflict between the interests of shareholders on the one hand (who may still have an interest in the company notwithstanding its financial difficulties, as the company may trade out of the difficulties) and the interests of creditors on the other hand, as they are the stakeholders who are truly at risk if the situation deteriorates into insolvent liquidation or insolvent administration.
- The majority of the Court held that the Creditor Duty is engaged when the directors knew or ought to have known about such insolvency or probable insolvency (i.e., this is a subjective and an objective test).
- However, where the company is irretrievably insolvent, the interests of those creditors become a 'paramount consideration' in the director's decision making. This is because at that point the shareholders no longer are considered to have any economic interest in the company.
- This also reflects the point at which directors are potentially liable under the 'wrongful trading' provisions of the Insolvency Act 1986,[1] where a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid entering insolvent liquidation or insolvent administration and failed to take every step with a view to minimising the potential loss to the company's creditors as the director ought to have taken.
- The Court also confirmed that transactions entered into in breach of the Creditors Duty cannot be ratified by unanimous decisions of the shareholders, unlike the case outside an insolvency situation.

Comment

Whilst it is helpful that the Court has confirmed that the Creditors Duty does **not** arise when there is merely a real but not imminent risk of insolvency, the advice to directors in times of actual or potential financial distress is unlikely to change following the judgement. This is because the Court did not set out the precise test for exactly when the Creditor Duty is engaged, which will be a matter of commercial judgment for the directors in any particular scenario.

Prior to the point of inevitable insolvency, the judgment describes a 'sliding scale' whereby the interests of creditors are considered and balanced against the interests of shareholders.

Given the current economic climate and potential increase in financial distress in UK companies, the judgment is a timely reminder to directors to consider creditors' interests in times of actual or anticipated financial distress.

The decision in *Sequana* strikes a balance between the interests of creditors in decisions taken by directors in times of financial distress on the one hand, and the need to allow directors to conduct the affairs of the company for the benefit of its members on the other hand.

Interestingly, the judgment considers that the 'interests of creditors' is a reference to the general body of creditors (i.e., where the Creditor Duty is engaged, the directors are required to consider the interests of creditors; they do not have to consider the interests of specific classes of creditors such as secured, unsecured, senior or subordinated creditors etc.).

The implication of this position is that when the Creditor Duty is engaged (and in particular, when the Creditor duty is paramount), then the directors would need to consider not only the interests of 'in-the-money' creditors but also the interests of 'out-of-the-money' creditors. The question this potentially leaves

[1] Section 214 and Section 246ZB of the Insolvency Act 1986.

open is whether out-of-the-money creditors, who have no economic interest in the company in an insolvent liquidation or administration, should be treated in the same way as equity in this situation? The judgment does not provide assistance on this point. However, informative on this point may be the *IMO Car Wash* case[2] in which the judge commented that:

> *"It was not disputed that the directors of an insolvent company have to pay proper regard to the interests of the creditors. However, what that duty means in practice will be very fact-sensitive."*

In that case the out-of-the-money mezzanine creditors had argued that the directors had breached their duties in not protecting their interests when they agreed restructuring terms with the senior (in-the-money) creditors. The judge rejected that proposition and said:

> *"The boards had had valuation material which suggested that the [mezzanine creditors] did not have an economic interest, and [accordingly] negotiated the scheme with the [senior creditors] That material did not make it obvious that the directors should be taking it upon themselves to negotiate an interest for a body of creditors [i.e. the mezzanine creditors] who had not managed themselves to negotiate an interest in direct negotiations. They did not conduct those negotiations. I am not surprised; the directors were not obliged to do so in those circumstances."*

In conclusion, there is no substitute for directors of a company which is facing actual or potential financial difficulties holding frequent board meetings and ensuring that all decisions are properly considered and documented. In accordance with the judgment in this case, Directors should also seek out and document appropriate legal and financial advice and keep themselves fully informed of the company's ability to meet future and contingent liabilities to help ensure that, if it they do reach the point at which the Creditor Duty is engaged, they can demonstrate that they have considered the interests of creditors and have given them appropriate weight.

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[2] *In the matter of Bluebrook Ltd and others* [2009] EWHC 2114 (Ch).