Directors' Duties Towards Creditors: Clarification by the Supreme Court

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BTI 2014 LLC v Sequana SA & Others [2022] UKSC 25

Factual Background

1. In December 2008 and May 2009, the directors of a UK limited company, known as Arjo Wiggins Appleton Limited ("AWA") distributed dividends to its parent company and sole shareholder, the defendant in the claim, Sequana SA ("Sequana"). The dividend payment in May 2009 was just over £119m.

2. At the time the dividend was paid, AWA was solvent both on a balance-sheet and cash-flow basis. But it had made provision in its accounts for a long-term pollution related contingent liability. The value of the cleaning up liability was extremely unclear and gave rise to a real risk, although not a probability, that AWA would potentially become insolvent at some point, but not an imminent date in the near future.

3. The clean up costs transpired to be more than the forecasted amount and, as a result, AWA became insolvent in October 2018.

4. The claimant, BTI 2014 LLC ("BTI") was an assignee of AWA's claims and brought proceedings to recover an amount equivalent to the May 2009 dividend from AWA's directors. This was on the grounds that their decision to pay the May dividend was a breach of their duty, under section 172(3) of the Companies Act 2006, to promote the success of the company ("the success duty"). At the same time, AWA's main creditor applied to recover the May dividend from Sequana, as a transaction defrauding creditors under section 423 of the Insolvency Act 1986.

High Court Decision

5. In the High Court, Rose J (as she was then) dismissed the claim in respect of the December dividend but found that the May dividend was caught by section 423. The court also dismissed the claim that the dividend constituted or gave rise to a breach of the directors' success duty under section 172(3). Rose J explained when the success duty would require directors to take into account the interests of the company's creditors:

   "The essence of the test is that the directors ought in their conduct of the company's business to be anticipating the insolvency of the company because when that occurs, the creditors have a greater claim to the assets of the company than the shareholders…there was a real possibility that AWA would never become insolvent or even close to insolvent…it cannot be right that whenever a company has on its balance sheet a provision in respect of a long term liability which might turn out to be larger than the provision made, the creditors' interests duty applies for the whole period during which there is a risk that there will be insufficient assets to meet that liability." [1]

6. Sequana appealed against the judgment under section 423. BTI cross-appealed against the dismissal of the section 172(3) claim.

Court of Appeal Decision

7. David Richards LJ delivered a thorough judgment, setting out when the success duty required the interests of creditors to be taken into account. He held:

   "…the duty arises when the directors know or should know that the company is or is likely to become insolvent…'likely' means probable…" [2]

8. The court explained that at the point of paying the May dividend, it could not have been said that AWA was likely to become insolvent. Thus, even if they had not taken into account the interests of creditors, the directors had not breached their success duty.

9. As for the section 423 claim, the appeal was dismissed. The court found that as dividends are both a commercial and legal return on investments, they cannot be categorised as a "gift" made by a company to its shareholders under section 423(1), but are capable of coming within the definition of a "transaction". Accordingly, the court held the payment of

[1] BTI 2014 LLC v Sequana SA and another [2017] Bus. L.R. 82, paragraphs 478 - 479.
[2] BTI 2014 LLC v Sequana SA and another [2019] Bus. L.R. 2178, paragraph 220.

the dividend to be a transaction at an undervalue that had been paid with the purpose of putting assets beyond the reach of creditors, or otherwise prejudicing their interests.[3]

10. BTI appealed the decision under section 172(3) to the Supreme Court.

Submissions in the Supreme Court

11. Given that AWA had been solvent at the time that it paid the May dividend (on both a balance sheet and commercial basis), BTI had to persuade the Supreme Court that the appropriate trigger for the engagement of interests of creditors, was at some point earlier than when the company actually becomes insolvent, and before (as the Court of Appeal had held) insolvency is *likely*. For its claim were to succeed, the point had to be when there is a "real risk" of insolvency. Only by that test would the potential insufficiency its provision for the contingent liability for clean-up costs, be sufficient to engage the success duty.

12. On the other hand, Sequana challenged the very existence of any rule of law that required directors to consider the interests of creditors under the success duty. If there was such a rule, Sequana challenged whether it could apply to a lawful dividend, and whether it could be engaged at any point earlier than actual or possible imminent insolvency. In the further alternative it supported the Court of Appeal's conclusion that a real risk of insolvency, falling short of a probability, would not engage the interests of creditors.

13. The Supreme Court had four issues before it:

    i. Was there a common law, fiduciary duty to consider the interests of creditors at all?

    ii. Was the payment of a dividend that was otherwise lawful, capable of constituting a breach of that duty?

    iii. What is the content of the duty?

    iv. When are the interests of creditors engaged?

Supreme Court Decision

Was There a Common Law Creditor Duty At All?

14. The Supreme Court considered a plethora of authorities and reached the conclusion that the common law recognised a rule under which the success duty (i.e. a director's duty to

[3] Paragraphs 58 and 63.

act in good faith in what they consider is in the interests of the company) might in some circumstances be understood as including the interests of creditors. The recent, modern origin of the rule is *West Mercia Safetywear Limited v Dodd* [4], and the rule was preserved by section 172(3) of the Companies Act 2006.[5]

15. It is not a self-standing duty owed to creditors, but one aspect of a director's fiduciary success duty owed to the company. It is consequently enforceable only by or on behalf of the company; or, in liquidation or administration, by the office-holder, or a creditor or contributory making an application under section 212 of the Insolvency Act 1986.[6]

When Are the Interests of Creditors Engaged?

16. It was sufficient, in order to dismiss the appeal, that the interests of creditors were not engaged simply because there was a "real risk" of the company becoming insolvent. The court nevertheless gave detailed, obiter, consideration of when the duty to consider creditor interests would be engaged.

17. The rationale for the rule is that, at a certain point approaching insolvency, a company's creditors have a substantial economic interest in it. Shareholders may have nothing more to lose (but perhaps much to gain) by ongoing trading, which gives rise to a risk that they will take decisions that adversely affect creditors. Lord Briggs, expressing the point a little differently, explained that it is only at the point that the company enters insolvent liquidation that creditors have the main economic stake in the company. Even so, it is the prospect that the creditors will attain that status, because the company is exposed to liquidation, that justifies the existence of a common law duty to consider creditor interests at that earlier stage.[7]

18. It was consequently held, first, that there is a duty to consider the interests of creditors once a company becomes financially distressed, meaning that it is insolvent or bordering on insolvency.[8] Secondly, the weight to be given to those interests will be fact sensitive, until the point that insolvent liquidation or administration becomes unavoidable, at which point the interests of creditors will become paramount.[9]

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[4] [1988] BCLC 250.
[5] BTI 2014 LLC v Sequana SA and Others [2022] UKSC 25, paragraph 111.
[6] Paragraphs 11 and 94.
[7] Paragraphs 86 (Lord Reed) and 147-148 (Lord Briggs).
[8] Paragraphs 88 (Lord Reed PSC), 203 (Lord Briggs), 207 and 227 (Lord Hodge) and 279 (Lady Arden).
[9] Paragraphs 77 and 80-81 (Lord Reed), 164-165 (Lord Briggs), and 247 (Lord

19. Thirdly, it was for a director to know, and keep abreast of, the company's financial situation. If they claimed not to be aware of its insolvency, the burden would be on them to show that they reasonably ought to be excused (i.e. due to third party fraud).[10]

Was the Dividend Payment That Was Lawful Capable of Constituting a Breach or Falling Within the Scope of That Duty?

20. Ultimately, the court was not required to make a finding on this issue given that it reached the conclusion that creditor duty had not engaged. However, the court gave guidance that creditor duty can apply to a decision by directors to pay a lawful dividend for two reasons.

21. Part 23 of the Companies Act 2006 regulates the payment of dividends. The court found[11]:
    i. Section 851(1) of Part 23 is subject to any rule of law to the contrary. Ergo, given that a creditor duty is part of common law, it cannot be treated as ousted by Part 23. Therefore, there was no sensible reason why the creditor duty under section 172(3) is excluded by Part 23.
    ii. Under Part 23, the availability of profits for distribution is assessed on a balance-sheet basis. That was not exhaustive of the circumstances in which payment of a dividend might be unlawful, for instance, if the company was commercially (i.e. cash flow) insolvent or the distribution would otherwise be out of capital.

22. As Lord Briggs explained: *"It cannot be the case that directors of a company already unable to pay its debts as they fall due could distribute a dividend, or do so if the consequence of the payment was to bring about cash flow insolvency."* [12]

What is the Content of the Creditor Duty?

23. The court found that the relevant duty is to consider creditors' interests, to give them their appropriate weight and balance them against the shareholders' interests where they may conflict. Consistent with the success duty, it is the directors' subjective judgment that is important. The court took the view that in certain circumstances, probably at the point that liquidation is unavoidable, the shareholders' interests will become subordinate and

Hodge).
[10] Paragraphs 90 (Lord Reed) and 279 – 280 (Lady Arden).
[11] Paragraphs 160 – 161.
[12] Paragraph 161.

directors must act in the interests of the creditors, whilst appreciating this was fact-sensitive.[13]

24. Much will depend on the "brightness" of the "light at the end of the tunnel", in other words:

    i. Whether the steps taken by directors will move the company away from threatened insolvency.

    ii. A balancing exercise between the shareholders and creditors, and who is likely to suffer the greater damage if the course of action taken does not succeed.[14]

Comments

25. The decision will no doubt be welcomed by directors and shareholders, as recognising the careful balancing exercise that is required when a company approaches or enters insolvency. It recognises the voluntary risks that creditors take by forming a legal relationship with a limited liability company, having carried out their own due diligence as to the financial stability and solvency of the company. It similarly recognises the limits to contractual self-protection, which justify a separate legal duty at the point that shareholders might be interested to trade at the creditors' expense.

26. The court found that there was not a free-standing creditor duty, rather that the fiduciary success duty was modified to require directors to take the interests of creditors into account where a company becomes financially distressed. The court clarified that the necessity to consider the interests of creditors arises when a company: (i) is bordering on insolvency; (ii) is insolvent; or (iii) will probably go into insolvent liquidation or administration.

27. In light of the current economic situation in the UK, this decision allows directors a margin of error, as well as protection to seek to move companies away from insolvency (i.e. promoting corporate rescue) without a substantial risk of adverse challenges by creditors. By retarding the point at which creditors' interests are engaged (not, as the Court of Appeal thought, when insolvency was probable, but the later point at which it was imminent), the decision promotes business enterprise and freedom to conduct business.

28. The counterbalance is that an onus is placed on directors to assess the solvency of their company, and to carefully evaluate whether a company can still see *"light at the end of the*

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[13] Paragraph 176.
[14] Paragraph 176.

tunnel" (as Lord Briggs put it) or whether insolvency is an inevitability. This is a fact-sensitive exercise and one that ought to be carried out carefully and with due diligence by directors, and appropriate professional advice.

29. The outcome reached by the court was sensible and takes into account the economic interests of the company as well as a balancing exercise between the shareholders' and creditors' competing interests. If one imagines a sliding scale, as a company nears liquidation, the interests of the creditors become more acute. The closer a company is to that point, the creditors' have a greater claim to the company's assets than the shareholders.

30. As the COVID-19 pandemic has shown, the progress towards insolvency is not always a gradual one, and can be sudden. The solution adopted by the Supreme Court reinforces the wrongful trading provisions of the Insolvency Act 1986, which make it paramount that directors are quick to respond when insolvency is an inevitability. Creditors' interests must then override those of shareholders. Equally, prior to reaching that point, while there is a prospect of a "rescue scheme" being implemented that avoids liquidation or administration, directors should assess the impact of any course of action upon the company's creditors.

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27 February 2023

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