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Sequana: UK Supreme Court Rules Directors' "Creditor Duty" Exists

– Arises When a Company is Bordering on Insolvency (But Not Before)

6 OCTOBER 2022

At a Glance

The UK Supreme Court yesterday delivered its long-awaited verdict in *Sequana*[1], on directors' fiduciary duties in the zone of insolvency, ruling that:

- When a company is "insolvent or bordering on insolvency", or an insolvent liquidation or administration is probable, the directors' duty to act in good faith in the interests of the company should be understood as including the interests of its creditors as a whole (the **creditor duty**). A "real risk of insolvency" is not sufficient to trigger this duty.
  - When the creditor duty arises, the directors should consider creditors' interests, balancing them against shareholders' interests where they may conflict. The greater the company's financial difficulties, the more the directors should prioritise creditors' interests.
  - Where an insolvent liquidation or administration is inevitable, creditors' interests become paramount as the shareholders cease to retain any valuable interest in the company.
- The relevant interests of creditors for this purpose 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.
- Where 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.
- The creditor duty can arise when directors are considering the payment of an otherwise-lawful dividend.
- On the facts of *Sequana*, the creditor duty was not engaged, because insolvency was not even probable at the relevant time.

IMPLICATIONS

This judgment is of considerable practical importance, especially in the current business environment.

- Directors of English companies must have regard to creditors' interests from the point at which 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.
- This duty applies where directors are considering the payment of a dividend, even where the accounts demonstrate sufficient distributable reserves.
- The judgment recognises that the rationale of limited liability is "to encourage risk taking as an essential part of commercial enterprise". Creditors are broadly expected to be the "guardians of their own interests". But – as ever – directors must keep the solvency of the company under careful review.

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For more information and practical tips on navigating directors' duties in stressed/distressed situations, please contact us.

1. *BTI 2014 LLC v Sequana S.A. and others* [2022] UKSC 25

Background

FACTS

- Company A, an English company, paid a dividend to its parent, S, at a time when A had ceased to trade and had a single liability: a material contingent liability under an indemnity, arising out of river pollution in the U.S.
- A later entered insolvent administration (almost 10 years following payment of the dividend).
- The creditors of A alleged that the provision in A's accounts for the indemnity liability was inadequate.
- The dividend was challenged on the bases that:
  - it was paid in breach of the duty of the directors of A to have regard to the interests of its creditors; and
  - payment of the dividend was a "transaction at an undervalue" under section 423 of the Insolvency Act 1986.[1]
- Claims were brought against A's directors (who authorised payment of the dividends) and against the parent, S (as a constructive trustee).

LAW OF "CREDITOR DUTY"

- The Companies Act 2006 codified the general duties owed by a director to a company.
  - Directors have a statutory duty 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.[2]
  - However, that duty is expressly subject to any rule of law requiring directors to consider or act in the interests of creditors of the company.[3]
- English courts have formulated a rule requiring directors to have regard to the interests of creditors in the "zone of insolvency", over the last 40 years.[4]
- The idea is that – when a company is actually or prospectively insolvent – the company's creditors have an economic interest in the company, based upon their entitlement to be paid the debts owed to them, ultimately enforceable against the proceeds of realisation of the company's assets.
  - Accordingly, where the company approaches insolvency, the interests of "the company" are in reality the interests of its creditors, as those with the main economic stake in the business.
- In *Sequana*, the question whether, if directors *are* indeed under a duty in respect of creditors' interests, that duty arises prior to insolvency, was raised for decision for the first time.
- The Court of Appeal in *Sequana* had held that the creditor duty arises "when the directors know or should know that the company is or is likely to become insolvent… In this context, "likely" means probable, not some lower test…".

1. The dividend had also been challenged on the basis it was not lawfully paid in accordance with the Companies Act 2006, but this issue no longer arose before the Supreme Court
2. Section 172(1), Companies Act 2006
3. Section 172(3), Companies Act 2006
4. *Re Horsley & Weight Ltd* (1982), *West Mercia Safetywear Ltd v Dodd* (1988) and other cases

Judgment

Is there a common law creditor duty at all?

- The Supreme Court affirmed that – in certain circumstances – directors' duty to act in good faith in the interests of the company is indeed 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 existence of that duty is now clear.
- This is an aspect of directors' fiduciary duty to the company, rather than a free-standing duty of its own: directors do not owe duties directly to creditors (nor to shareholders).
- Contrary to suggestions in earlier cases, the creditor duty does not mean creditors have a quasi-proprietary interest in the assets of the company.

When does the creditor duty arise?

- The Supreme Court held that where the company is insolvent, or bordering on insolvency (but is not necessarily 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 creditor duty does not arise earlier – e.g. wherever there is a "real as opposed to remote risk" of insolvency or where the company is "likely to become insolvent". Such a test – applied with the benefit of hindsight – might impose an "impracticable burden" upon directors.
- The Supreme Court judgment leaves open the question of whether it is essential that 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), as the judges expressed conflicting views on this issue.
- On the facts of *Sequana*, the creditor duty had not arisen at the relevant time, when the dividend was paid.

How much weight should be given to the creditor duty?

- Where shareholders' and creditors' interests are in conflict, a balancing exercise will be necessary.
- The greater the company's financial difficulties, the more the directors should prioritise the interests of creditors. "Much will depend upon the brightness or otherwise of the light at the end of the tunnel."
- Where an insolvent liquidation or administration is inevitable, the creditors' interests become paramount, as the shareholders cease to retain any valuable interest in the company (and therefore their interests cease to bear any weight).

Can shareholders authorise or ratify a breach of the creditor duty?

- No: the Supreme Court confirmed that where the creditor duty has arisen such that 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.
- This is because there can be no shareholder ratification of a transaction entered into when the company is insolvent, or which would render the company insolvent.

Can payment of otherwise-lawful dividends amount to a breach of the creditor duty?

- Yes: the Supreme Court held that a decision to pay dividends can amount to a breach of the creditor duty.
- However, there was no breach of this duty on the facts of *Sequana*, because the company (A) was not insolvent or bordering on insolvency when the dividend was paid.

Implications

- This long-awaited judgment from the UK's highest court provides the definitive say on the creditor duty: it *does* exist (as an aspect of directors' fiduciary duty to the company), and it arises from when the company is bordering on insolvency – but not before.
- This offers welcome comfort to boards of directors that the courts will adopt a commercial approach: the creditor duty is not engaged simply when there is a real risk of insolvency.
- The Supreme Court's judgment recognises that the rationale of limited liability is "to encourage risk taking as an essential part of commercial enterprise".
- Creditors are broadly expected to be the "guardians of their own interests".
- As ever – directors must keep the solvency of the company under careful review.
  - It is notoriously difficult to ascertain the precise tipping point at which a company is insolvent or bordering on insolvency – a task inevitably undertaken in the rear-view mirror. As ever, thorough record-keeping and professional advice is essential in stressed/distressed scenarios.
  - In particular, directors of stressed/distressed companies should consider whether the creditor duty is engaged when determining the payment of a dividend – even where the accounts demonstrate sufficient distributable reserves.
  - For further practical tips, please contact us.

Balance of stakeholders' interests in the zone of insolvency

SHAREHOLDERS' INTERESTS

CREDITORS' INTERESTS

No / remote risk of insolvency	
Real risk of insolvency	
Directors ought to be anticipating insolvency	Test considered by court of first instance in *Sequana*
Directors know or should know that company is, or is likely to become, insolvent (likely = probable)	Test adopted by Court of Appeal in *Sequana*
Insolvent or bordering on insolvency (or insolvent liquidation / administration is probable)	**Test adopted by Supreme Court in *Sequana*** (leaving open question of whether directors must know / ought to know)
No real prospect of avoiding insolvent liquidation / administration	Engages "wrongful trading" duty[1]
Actual insolvency – i.e. unable to pay debts as they fall due, or company's assets are worth less than its liabilities	

1. Under Section 214, Insolvency Act 1986 – potential liability for directors unless they take **every** step with a view to minimising losses to creditors.

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