OUR GUIDE TO DIRECTORS' DUTIES TO CREDITORS

The Supreme Court has recently (5 October 2022 – *BTI 2014 LLC v Sequana S.A.*) given its judgement in relation to the question:

"whether the trigger for the directors' duty to consider creditors is merely a real risk of, as opposed to a probability of or close proximity to, insolvency".

It is confirmed that the creditor duty does indeed exist. However, when precisely a company is viewed to be insolvent is entirely dependent upon the facts of the case. It is, therefore, advisable for company directors to continue to act cautiously when considering if the duty is engaged.

What were the facts in Sequana?

Very briefly, a subsidiary of Sequana was liable to indemnify BTI for the costs of cleaning a polluted river. The directors of the subsidiary caused that company to pay a significant divided to Sequana, resulting in there not being enough money in the subsidiary to pay for the clean-up costs.

BTI brought a breach of duty claim against the directors of the subsidiary who authorised the dividend payment, arguing that it had been paid in breach of their duty to have regard to the interests of the company's creditors.

The directors' fiduciary duty to creditors

It has long been established that a director has a fiduciary duty to act in a way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole[i]. However, there is a common law rule that this duty is modified upon the company becoming insolvent, such that the company's interests are said to equate to those of its creditors, which a director must therefore have regard to.

Why is the creditor duty important?

At what point this duty is engaged, prior to a formal insolvency appointment, impacts upon not only when directors should resolve to place a company into Liquidation or Administration, but also whether they can be held personally liable for decisions they subsequently take.

The Sequana judgement

The Judge at the first trial found that Sequana's subsidiary's risk of a future insolvency at the time the dividend was paid was not enough to trigger the duty to creditors. BTI appealed this decision and the Court of Appeal was asked when and in what circumstances the duty arises?

The Court of Appeal dismissed the appeal, supporting the initial Judge's decision that the creditors' interest duty was not triggered on the facts of the case. It concluded that there were four possible answers to the question of when it could be:

1. when a company is actually insolvent;
2. when it is on the verge of or nearing or approaching insolvency;
3. when the company is or is likely to become insolvent; and
4. where there is a real, as opposed to a remote, risk of insolvency.

The Court of Appeal determined that the creditor duty could be triggered earlier than an actual insolvency, (1). Specifically, it included (2) and (3): "when the directors know or should know that the company is or is likely to become insolvent". Likely, in this context, means a greater than 50% probability of the insolvency happening.

BTI appealed again to the Supreme Court.

The Supreme Court dismissed the appeal on the specific facts of the case. However, on the general issues the Supreme Court helpfully provided the following guidance.

Is there a creditor duty at all?

It has been determined that there is. A director's duty to act in good faith and in the company's interests **is** modified prior to an insolvency resulting in the company's interests including the interests of its creditors as a whole. Directors, in those circumstances, must have regard to and consider the interests of a company's current and prospective creditors.

The duty was confirmed for a number of reasons, including that creditors of a company have an obvious economic interest in it and its assets, distinct from the interests of the company's shareholders, which increases in relative importance when the company is bordering on insolvency.

What is the duty?

The duty to act in the company's interests reflects the fact that both its shareholders and creditors have an interest in its affairs, but which may not align. Once it is triggered, the creditor duty requires a director to have regard to the interests of the company's general body of creditors (not any one particular creditor), as well as the general body of shareholders, and to act accordingly. Where the creditors' and shareholders' interests conflict, a balancing exercise is necessary. The worse a company's financial position becomes, the more the creditors' interests will outweigh the shareholders', until they eventually become paramount when a company is irretrievably insolvent, at which point the shareholders no longer have any valuable interest in the company.

When is the creditor duty engaged?

The particular triggers (1 to 4 above) were considered by the Supreme Court, which effectively accepted that they would include (1), (2) and (3): "imminent insolvency", or the "probability of an insolvent liquidation or administration", which the directors "know or ought to know about" and when the company is "insolvent or bordering on insolvency".

The earliest possible trigger, (4), "a real and not remote risk of insolvency" was rejected.

Our conclusion

The conduct of directors will be judged against the specific financial circumstances of a company and it is, therefore, vital that directors who have concerns about the future solvency of their company take clear, practical advice at the earliest opportunity to avoid personal liability at a later date.

If you would like specific guidance for you or your company, talk to Sadlers today.

---

[i] Section 172(1) of the Companies Act 2006