The Supreme Court of the United Kingdom Recognises "Creditor Duty" in Momentous Decision—but Many Questions Remain

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"*The Court is of one mind that there needs to be certainty in this area as far as possible*", stated Lady Arden in the "*momentous*" decision in *BTI 2014 LLC v Sequana SA & Ors* [2022] UKSC 25, which for the first time saw the United Kingdom's highest court recognise that the directors of a company who know or ought to know that the company is insolvent or bordering on insolvency are obliged to consider the interests of the company's creditors and prospective creditors. And yet, in recognising that the duty to the company exists, there remains debate about when the duty is triggered and the extent of its scope. It may be that the Supreme Court will need to address the more complex points in the future, perhaps where the facts of the case are more conducive to doing so.

Equally troubling for the need for certainty is that three of the United Kingdom's preeminent company and insolvency law judges (Lord Richards (now on the Supreme Court bench but then sitting in the Court of Appeal), Lord Briggs and Lady Arden, who has now retired) have come to differing conclusions on these two key issues, which remain obiter given the facts of the case.

Below we examine the Supreme Court's decision and set out some practical considerations for company directors, but by way of summary:

- It would seem that directors of UK companies are required to consider the interests of creditors in the exercise of their fiduciary (and statutory) duties to the company 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.

- In such circumstances where the duty requires directors to consider creditors' interests and those interests conflict with shareholders' interests, directors must engage in a balancing exercise.

- The more precarious the company's financial state, the greater the emphasis to be placed on consideration of creditors' interests to the exclusion of shareholders'

interests. When insolvent liquidation becomes inevitable, the interests of creditors are likely to be paramount.

- This duty also applies when directors are looking to approve what would otherwise be lawful distributions by way of dividends under Part 23 of the Companies Act 2006 and otherwise in compliance with common law capital restrictions.

Background

Before turning to the legal analysis, it is helpful to have a high-level summary of the facts of the appeal in mind.

In May 2009, the directors of Arjo Wiggins Appleton Limited ("AWA") caused it to distribute almost the entirety of its remaining net assets to its French parent company, Sequana SA. They did so by approving a €135 million dividend. AWA, however, was a non-trading entity which existed for the sole purpose of meeting liabilities for clean-up costs of the Fox River in Wisconsin, USA, and had already reduced its share capital from €318.6 million to €1 million and made a sizeable dividend to Sequana in December 2008 of €443 million. At the time of distributions, there was significant uncertainty as to the precise quantum of the clean-up costs, which was the subject of litigation in the United States, however, AWA was solvent.

British American Tobacco Plc ("BAT") had in turn guaranteed the discharge of AWA's liability for the clean-up costs of the Fox River following the separation of AWA from the BAT group and its later acquisition by Sequana. As it happened, several years after the dividends were made, the cost of the remediation works was shown to have greatly exceeded the original estimates, which AWA thought would be met by an historical insurance policy—they were not. Consequently, AWA became insolvent.

Relevantly, the May 2009 dividend was the subject of two claims: (i) a claim under s. 423 of the Insolvency Act 1986 (transactions defrauding creditors) and (ii) claims against AWA's directors for breach of duty in approving the dividend. The first of these claims was successful in the High Court and in the Court of Appeal, and was not the subject of the Supreme Court appeal.

The appeal before the Supreme Court concerned only the May 2009 dividend breach of duty claims. The Judge at first instance, Rose J (as she then was), had dismissed the breach of duty claim. BTI 2014 LLC ("BTI") (the assignee of the assigned claims from AWA to BAT) then argued in the Court of Appeal that even though the May 2009 Dividend was lawfully paid under Part 23 of the Companies Act 2006 and within the

ambit of the common law restrictions on distributions to shareholders, AWA's directors were in breach of the common law duty arising under s. 172(3) of the Companies Act 2006 to consider the interests of creditors because making the dividend involved a real as opposed to remote risk that AWA would become insolvent.

The Court of Appeal (David Richards LJ (as he then was), with Longmore and Henderson LJJ agreeing) found that whilst the "creditor duty" was part of English law, the trigger point was not "*a real as opposed to a remote risk of insolvency*", albeit that the duty could arise before actual insolvency. According to the Court of Appeal, the duty arises "*when the directors know or should know that the company is or is likely to become insolvent* … [in which] *'likely' means probable*": [215]-[220]. Accordingly, BTI's argument that the duty was engaged at an earlier time failed.

The Supreme Court's Decision

The Supreme Court had to answer four questions and in doing so was divided on two crucial points—when the duty arises and what is its content. Lord Briggs (with whom Lord Kitchin agreed) wrote the majority judgment, with Lord Hodge writing a concurring judgment. Lord Reed and Lady Arden wrote separate judgments. All agreed that the formulation contended for by BTI was not correct and that the appeal should accordingly be dismissed.

Is There a Common Law "Creditor Duty"?

Yes. All Justices found that the duty exists but it is not a standalone duty owed by directors directly to creditors. Rather, it is a duty which the directors owe to the company as with other fiduciary and statutory duties. According to the majority, the principled bases for the duty to consider creditors' interests are: (i) that creditors may become the paramount stakeholders when a company enters insolvent liquidation; (ii) that there is a long line of authority in England, Australia and New Zealand affirming its existence (albeit that Canada, Delaware and other U.S. jurisdictions rejected the duty); and (iii) its existence at common law was affirmed by the enactment of s. 172(3) of the Companies Act 2006, which states that the duty in s. 172 to promote the success of the company "*has effect 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*". Lord Reed and Lady Arden agreed that s. 172(3) preserved (but did not affirm) the common law duty. Lady Arden also thought that the duty to consider creditors' interests formed part of the s. 172(1) duty to act in the best interests of the company when the company was in financial distress.

Can the "Creditor Duty" Apply to a Decision by Directors to Pay a Lawful Dividend?

All Justices agreed that it can. First, Part 23 of the Companies Act 2006, which together with the common law regulates the payment of dividends by UK companies, is expressed to be subject to any rule of law contrary to its provisions per s. 851(1). As the "creditor duty" is a common law rule of law, Part 23 is therefore subject to it. Second, and agreeing with David Richards LJ in the Court of Appeal, the majority noted that Part 23's focus is on identifying profits available for distribution by looking at a company's balance sheet. It would be illogical for the "creditor duty" not to apply to dividends conforming to the requirements under Part 23 and the common law but where the company was cash flow insolvent (but not balance sheet insolvent) or would become so because of the distribution.

What Is the Content of the "Creditor Duty"?

There was some debate about this. The majority found at [176] that "*prior to the time when liquidation becomes inevitable and section 214 becomes engaged* [being the wrongful trading provisions in the Insolvency Act 1986], *the creditor duty is a duty to consider creditors' interests, to give them appropriate weight, and to balance them against shareholders' interests where they may conflict*". This may require creditors' interests to be treated as paramount when compared to shareholders' interests when liquidation is inevitable and is likely to be a fact-sensitive question. Lord Hodge simply stated that he was "*satisfied that the directors of a company which is insolvent or is bordering on insolvency owe a duty to the company to have proper regard to the interests of its creditors and prospective creditors*": [207], see also Lord Hodge at [238].

Lord Reed expressed a provisional view that, once triggered, "*the directors' fiduciary duty to act in the company's interests has to reflect the fact that both the shareholders and the creditors have an interest in the company's affairs*": [81]. Lord Reed recognised that there may be conflicts between the two sets of interests and that a balancing act will be required, but "*the more parlous the state of the company, the more the interests of the creditors will predominate, and the greater the weight which should therefore be given to their interests as against those of the shareholders. This is most clearly the position where an insolvent liquidation or administration is inevitable …*": [81].

Lady Arden went further than the other Justices by considering that the content of the rule extends to directors being under a duty to not materially harm the interests of creditors: [290].

Given the fact-sensitive nature of the approach, there is little principled guidance in the judgment to assist directors. The clearest indication appears to be Lord Briggs' analysis at [176] set out above. This seems to suggest that, prior to inevitable liquidation, a

director must consider creditors' interests and balance them against those of shareholders. However, as the economic stability of the company worsens, greater weight must be given to creditors over shareholders, sometimes to the extent that creditors' interests become paramount. The real difficulty, though, as Lord Briggs appreciates, is that sometimes directors reasonably believe that certain actions will lead a company out of financial difficulty or insolvency. One must then ask "*who risks the greatest damage if the proposed course of action does not succeed*" and focus on their interests: [176]. When insolvent liquidation appears inevitable, creditors' interests are more likely to become paramount.

When Is the "Creditor Duty" Engaged?

It is certainly engaged at the time of actual insolvency, but with equal certainty, it is not engaged when there is simply a real as opposed to remote risk of insolvency. On the facts of the particular case, it was otherwise unnecessary to decide exactly when the "creditor duty" is triggered prior to actual insolvency, but the Justices considered the timing point in any case.

Lord Briggs was clear that a real risk of insolvency trigger was too far from actual insolvency, which "*turns a creditor's prospective entitlement into an actual one*". The ratification principle (by which shareholders can ratify directors' breaches of fiduciary duty) was also relevant to the question of timing. The ratification principle ceases to apply when a company becomes insolvent or is facing insolvency, the rationale being that shareholders can waive or ratify breaches affecting themselves but not a company's creditors. Therefore, it would be inappropriate for the "real risk" test to apply given that it would bite earlier than when the ratification principle would cease to apply.

Taking the competing trigger points in turn, David Richards LJ in the Court of Appeal thought that the trigger was when the directors know or should know that insolvency is probable (i.e., more likely than not). At [203] Lord Briggs expresses the obiter view that "*I would prefer a formulation in which either imminent insolvency (i.e. an insolvency which directors know or ought to know is just around the corner and going to happen) or the probability of an insolvent liquidation (or administration) about which the directors know or ought to know, are sufficient triggers for the engagement of the creditor duty. It will not be in every or even most cases when directors know or ought to know of a probability of an insolvent liquidation, earlier than when the company is already insolvent. But that additional probability-based trigger may be needed in cases where the probabilities about what lies at the end of the tunnel are there for directors to see even before the tunnel of insolvency is entered*".

Lord Briggs also agreed with Lord Hodge's judgment that the duty arises "*at a point in time at or near the onset of insolvency*": [231] or when a company is "*bordering on*

insolvency": [238]. Lord Reed also referred to the test applying when a company is insolvent or bordering on insolvency but disagreed with the reasoning behind David Richards LJ's "likelihood" test of probability.

Significantly, Lord Reed preferred not to offer a concluded view on whether directors must "know or ought to know" that a company is insolvent or bordering on insolvency, stating only that he was less certain about the requirement. Lady Arden too left that issue for another time but preferred a trigger focusing on irreversible insolvency making insolvent liquidation unavoidable as the point when creditors interests reach paramountcy: [311].

One question arising on the appeal about which little was said is what is meant by "insolvency". The majority referred to either cash flow or balance sheet insolvency within the meaning of ss. 123(1)(e) and 123(2) of the Insolvency Act 1986 but thought that the duty should not arise during short-term cash-flow insolvency (otherwise known as commercial insolvency): [120]. Lord Reed expressed a provisional view that it can be answered by reference to the cash-flow and balance-sheet insolvency provisions too: [80]. Lady Arden thought that this was a good starting point but that such tests should be applied "*with a degree of flexibility appropriate to the rationale and context*" of the "creditor duty": [307]-[310]. Her Ladyship agreed with Lord Briggs, however, that temporary cash-flow insolvency should not trigger the duty.

Where Does This Leave Company Directors?

Directors of UK companies might well be thinking, "where does this leave me?", especially in view of the worsening economic climate which may give rise to more frequent insolvencies. Here are some points to consider:

- The starting point is to reiterate that a director of a UK company owes a duty to the company to consider the interests of creditors if the company is insolvent. However, this is not a standalone duty owed to creditors but a variation of the fiduciary duty owed by a director to act in the interests of the company.

- Formally, it remains an open question as to when prior to insolvency the duty applies. The strong guidance from the Supreme Court is that the duty will be triggered when a company is (i) bordering on insolvency or (ii) imminently insolvent (in the sense that the directors know or ought to know that insolvency is just around the corner), or (iii) the directors know or ought to know that insolvent liquidation or administration is probable (i.e., more likely than not). The duty should not apply when a company experiences temporary cash-flow insolvency.

- Directors should be careful to abide by their other ss. 171-177 Companies Act duties and in particular keep well informed about the financial standing of the company. Obtaining regular and reliable financial data is essential, especially given the references to the "creditor duty" being triggered when a director knows or ought to know of imminent or probable insolvency.

- Prior to imminent or actual insolvency, directors should consider the interests of creditors and balance them against the interests of shareholders when interests conflict. When there is imminent or actual insolvency, directors may need to consider the interests of creditors over those of shareholders. Therefore, where there is any doubt about solvency, directors should give proper thought to the interests of creditors before authorising any transactions and be satisfied that the transaction is in the interests of the company and/or its creditors, depending on the precise factual context. They should consider creditors as a class rather than on an individual basis.

- Before authorising any dividends which would otherwise be lawful within the ambit of Part 23 of the Companies Act and other common law rules, directors must also consider creditors' interests if there may be solvency issues.

- As the duty is owed to the company and not its creditors any cause of action for breach of the duty is vested in the company (or its liquidators), the fruits of which will flow to the company or into the insolvent estate for distribution according to the insolvency waterfall.

- Recognition that the creditor duty exists under English law is particularly important for directors of UK companies who are from a jurisdiction that does not recognise the creditor duty (e.g., Canada, Delaware and other U.S. jurisdictions). It is also worth keeping in mind if you are a director of a company registered in one of the United Kingdom's Crown Dependencies or British Overseas Territories (e.g., the Cayman Islands, British Virgin Islands, Jersey etc.) because those jurisdictions often follow English law in the absence of their own binding precedents, albeit that the Supreme Court's decision is not directly binding on such jurisdictions.

- The "creditor duty" applies to de jure, de facto and shadow directors.

- Given that the Supreme Court's decision narrows the application of the "creditor duty", other creditor-protection provisions under the Insolvency Act may be of greater assistance to creditors, including a creditor's ability to seek compulsory winding up under s. 122(1)(f) of the Insolvency Act 1986. Some provisions do not subject directors as a class to personal liability but are instead focused on unwinding transactions—for example, ss. 238 and 239 of the Insolvency Act 1986 permit the reversal of transactions at an undervalue and wrongful preferences. Section 214,

however, permits a court to order a director to pay compensation to the company where there has been wrongful trading. Each of these provisions only apply when a company is insolvent as opposed to when it is bordering on insolvency.

- Claims under s. 423 of the Insolvency Act 1986 may play a greater role because of the narrowing of the "creditor duty", especially as s. 423 does not require a company to be insolvent. Section 423 allows a victim of a transaction entered into at an undervalue to apply for relief where the purpose of the transaction was to put assets beyond the reach of the victim or otherwise to prejudice the victim's interests. BTI's s. 423 claim in respect of the May 2009 dividend was indeed successful even though there was no breach of the "creditor duty" because the company was too far from the zone of insolvency. Given Sequana's later insolvency, though, this victory may turn out to be pyrrhic, but in other cases it may not be so.
- Lord Briggs also raised the possibility that a claim could have been brought against the directors for breach of duty on the basis of the breach of s. 423 by the company. In the absence of insolvency, however, shareholders could ratify the directors' acts, so even this potential avenue may have limits.

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