UK Supreme Court Rules in Favour of Directors in Seminal Case on Directors' Duties in 'Zone of Insolvency'

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In what Lady Arden described as a "momentous decision for company law," the Supreme Court of the United Kingdom has confirmed that there are circumstances in which company directors are required to consider the interests of creditors and has given guidance on when the duty arises. Delivering judgment in *BTI 2014 LLC v Sequana SA and ors* [2022] UKSC 25[1] (Sequana) on 5 October 2022, the Supreme Court acknowledged that the requirement to consider the interests of creditors may arise prior to insolvent administration or liquidation becoming inevitable, but made clear that until insolvent liquidation or administration was inevitable, creditor interests would not necessarily be paramount.

The judgment addresses long-standing uncertainty about the existence of such a duty in English law and the circumstances in which it arises. The Supreme Court's acknowledgement of the importance of not chilling director efforts to rehabilitate troubled companies by imposing an overly rigid standard, or one which will be too easily triggered, will provide comfort to directors and those advising them.

Background

Directors and advisers have long understood that as a company nears insolvency, there are situations where the economic interest in a board's decision-making process sits, at least in part, with the creditors. While North American courts have tended to reject any specific requirement that directors consider the interests of creditors, courts in Australia and New Zealand, and more recently in England (in *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250 and the cases that followed it), have recognised that such a requirement exists. When it arises, however, what exactly is required and how the requirement interacts with the statutory protections applicable in insolvency have remained unclear.

This uncertainty, and particularly the possibility that a duty may arise as early as when there is a "real, as opposed to a remote" risk of insolvency (as the appellant contended in *Sequana*), had the potential to leave directors and their advisers with no option but to assume the worst, potentially hampering efforts to rehabilitate or restructure companies to the benefit of all stakeholders, or leading to overly cautious, and hence unproductive, decision-making.

The Issues in *Sequana*

The litigation concerned dividends an English company (AWA) paid to its sole shareholder Sequana SA (the first respondent), which it was argued impacted AWA's ability to satisfy certain indemnities in relation to historic pollution in the Fox River in the state of Wisconsin, in the United States. In 2009, the directors of AWA (the second to third respondents) determined that the most likely quantum of AWA's liability under such indemnities was less than the value of the insurance it held, and accordingly, that it was solvent and able to pay dividends. A dividend of €135 million was paid to Sequana in May 2009. That dividend complied with the statutory scheme regulating the payment of dividends in Part 23 of the Companies Act 2006 (the 2006 Act) and with the common law rules on the maintenance of capital. At the time it was paid, AWA was solvent on both a balance sheet and a cash flow basis.

The environmental liabilities, however, ended up being substantially greater than estimated, with the result that AWA was not able to satisfy its indemnity obligations and went into insolvent administration almost 10 years later, in October 2018. The

[1] Skadden represented Sequana SA and the former directors of one of its subsidiaries, AWA, in this case.

shareholder Sequana and AWA's directors were sued by BTI 2014 LLC as an assignee of AWA's claims.

The claimant argued at trial and in appeals to the Court of Appeal and the Supreme Court that the directors had a duty to consider the interests of creditors when they paid the 2009 dividend, because at that point there was a real and not remote risk of AWA becoming insolvent. In the Court of Appeal, David Richards LJ rejected the proposed test of "real, as opposed to a remote" risk of insolvency but concluded that such a duty exists when a company is more likely than not to become insolvent. The claimant appealed to the Supreme Court.

Is There a Duty To Consider the Interests of Creditors?

Section 172(1) of the 2006 Act requires directors 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, and in doing so to consider a list of specific factors. The section is a codification of the long-established common law fiduciary duty and embodies the concept of "enlightened shareholder value." The list of additional factors to be considered does not, however, include creditors. Rather, section 172(3) expressly preserves any existing common law rule requiring directors to consider the interests of creditors, if such rule exists.

The Supreme Court unanimously agreed that the common law does provide that in certain circumstances, directors are required to consider the interests of creditors. In doing so, the Supreme Court confirmed the underlying concept as developed in the line of lower court cases commencing with *West Mercia*.

There is, however, no independent "creditor duty." Rather, the Supreme Court described the rule as merely a modification of the directors' fiduciary duty to the company, widening the scope of the interests which are taken into account when considering the company's interests, so as to include creditors' interests as well as shareholders'.

When Is the Duty Triggered?

A key issue for directors of companies facing financial difficulties has been to know when they are required to consider the interests of creditors. The Court of Appeal's decision in *Sequana*, which held that the duty was triggered when it became more likely than not that at some point in the future the company would become either cash flow or balance sheet insolvent, left directors and their advisers taking a risk-averse approach to the assessment of such probability.

The Supreme Court unanimously rejected that trigger point, with a majority (Lord Briggs, with whom Lord Kitchen agreed, and Lord Hodge) holding that the duty arises when directors know, or ought to know, that the company is actually insolvent or bordering on insolvency, or that an insolvent liquidation or administration proceeding is probable. The Supreme Court emphasised that the duty would arise where insolvency was imminent, and that imposing a fetter on director decision-making at an earlier point should be rejected.

What Is the Content of the Creditor Duty?

The Supreme Court acknowledged that the appropriate course of action for directors of companies faced with potential insolvency is highly fact sensitive and requires a weighing of interests and exercise of judgment.

Lord Briggs noted that unless insolvent liquidation or administration is inevitable, the duties of directors have to reflect the fact that "both the shareholders and the creditors have an interest in the company's affairs [and that in] those circumstances, the directors should have regard to the interests of the company's general body of creditors, as well as to the interests of the general body of shareholders." He made clear that where those interests conflict, a balancing exercise will be necessary.

The majority was clear also that creditor interests do not become paramount, at least until an insolvent liquidation or administration is inevitable. Lord Briggs noted specifically that it would be wrong for the common law to recognise an obligation which would result in directors deciding, or being advised for their own protection, to immediately cease trading when there remains a light at the end of the tunnel.

In a statement which should provide significant assurance for directors of troubled companies, Lord Hodge said:

> A reasonable decision by directors to attempt to rescue a company's business in the interests of both its members and its creditors would not in my view involve a breach of the common law duty.

Conclusion

The Supreme Court's decision is a significant milestone in the development of the English common law in relation to directors' duties and provides welcome certainty to directors and their advisers. The Supreme Court's emphasis on the necessity of balancing creditor and shareholder interests, and on not dissuading directors from seeking to achieve a restructuring or rescue, is consistent with the "rescue culture" which has been a key focus of development of English corporate law since the Enterprise Act 2002 and which has been furthered by the creation of the "Restructuring Plan" procedure under Part 26A of the 2006 Act and other recent reforms.

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