Directors' Obligations to Creditors: *BTI2014 v Sequana* in the Supreme Court

INTRODUCTION

Long-awaited and widely billed as one of the most important D&O decisions in a generation, the Supreme Court's judgment in *BTI 2014 v Sequana* [2022] UKSC 25 was handed down last week. This considers the extent to which company directors owe duties to creditors, when any such duties might arise and what the extent of them might be.

We have therefore prepared a note on the judgment

Lady Arden set the tone in the opening words of her judgment when she said, "*This is as momentous a decision for company law as this Court's recent decision in Patel v Mirza [2017] AC 467 was for the law of illegality and whether claims are barred by illegality*". This has been echoed in much of the commentary on the case. It is not hyperbole. *Sequana* is on any view an important case on D&O liability.

The central questions before the court were whether company directors owe a duty to creditors and, if they do, what the ambit of the duty is and in what circumstances it arises.

THE EXISTING LAW

The starting point is that a director's duties are owed to the company. These include a duty to act in good faith in the interests of the company. Some of the older cases treat the interests of the company as being a shorthand for the interests of its shareholders, but it is long established (and was at the time of several of the cases in question) that a limited company has a separate existence independent of its shareholders.

The distinction might seem more conceptual than of any practical significance. Indeed, the Supreme Court readily accepted that for as long as the company is financially stable, the directors can treat shareholders' interests as the company's interests. The battleground in *Sequana* was over the extent to which creditors' interests needed to be taken into account if the financial position of the company deteriorated.

Early cases took a robust *laissez faire* approach. Those who did business with limited companies, the reasoning went, knowingly took a commercial risk and it was for them to determine how they might protect their investment.

The case of *Wincham Shipbuilding* (1878) 9 Ch D 328 exemplified this. In that case, the defendants were the directors and shareholders of an insolvent company and had guaranteed its overdraft. Two days before creditors presented a winding up petition, they caused the company to make payments which eliminated their liability under the guarantee to the detriment of the creditors.

The Judge found that this amounted to a breach of trust but the Court of Appeal disagreed. Jessell MR said, "*it appears to me the question is, for whom were they trustees?... It has always been held that the directors are trustees for the shareholders, that is, for the company*…."

A different approach emerged in the 1980s. In the influential Australian case of *Kinsela v Russell Kinsela Pty* (1986) 4 NSWLR 722, Street CJ concluded that it was no answer for directors of an insolvent company to say that the shareholders had authorised a transaction calculated to put assets out of the reach of creditors. He said:

> *"In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditor intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets."*

This was cited with approval by Dillon LJ in *West Mercia Safetywear v Dodd* [1988] BCLC 250, which was the wellspring of the creditor duty in this jurisdiction. It has been followed in numerous, mostly first instance, decisions since then. The caselaw has developed in much the same way in Australia and New Zealand. In Canada and certain US states, by contrast, the courts have rejected the idea of a creditor duty. Even in those jurisdictions where it was seemingly well-established, however, it has been the subject of trenchant academic criticism.

THE FACTS

Arjo Wiggins Appleton Limited ('AWA') was a paper manufacturing company based in the UK. Its history involved a series of mergers, demergers and name changes. Along the way, it had picked up the liabilities of two paper coating companies in Wisconsin. In the 1950s and 1960s, these companies had been responsible for extensive pollution of the Lower Fox River. Claims to recover the clean-up costs were notified in the 1990s. The French company, Sequana SA ('Sequana') acquired AWA in 2000. It ceased trading the following year.

By 2008, AWA had a provision in its accounts of €62.8m for the contingent liabilities arising from the pollution claims. This figure was the difference between the insurance cover it held and the directors' best estimate of the potential liabilities. The accounts showed net assets of €517m. The directors agreed to pay a dividend to Sequana of €443m. A restructuring left distributable reserves of €137m.

In reviewing the position the following year, the directors concluded that the available insurance cover ought to be sufficient for the contingent liabilities. It appears to have been common ground that the uncertainty nevertheless meant that there was a real risk that contingent liabilities might lead to insolvency at some indeterminate point in the future. The directors agreed to pay a further dividend to Sequana of a little over €135m.

Ten years later, the risk materialised. AWA went into administration. The Appellant, as assignee of AWA's rights, brought a High Court action against the directors. It failed to persuade either the Judge or the Court of Appeal that the rule in *West Mercia* was triggered by a real risk of insolvency. It appealed to the Supreme Court. The Respondents argued against the existence of the creditor duty. They maintained that *West Mercia* was wrongly decided in failing to take account of *Wincham Shipbuilding* and that the creditor duty was incompatible with the ratification principle and the statutory regime.

THE JUDGMENT

The existence of the duty

It was always ambitious of the Respondents to try to persuade the court that the creditor duty does not exist at all. To accept this would have involved unpicking a significant body of authority dating back to the 1980s. Perhaps unsurprisingly, the argument failed.

Lord Briggs (with whom Lords Kitchin and Hodge agreed) acknowledged that the *"combination of academic criticism, earlier inconsistent authority and the undoubted parallel existence of the older ratification principle do amount to a formidable basis for undertaking a re-appraisal of the very existence of the creditor duty*". He agreed that there was force in some of the criticisms but was satisfied that the creditor duty was right in principle and should stand. The court was unanimous in affirming it.

It swatted away *Wincham Shipbuilding* as premised on an outdated approach to directors' duties and creditor protection. Lord Briggs observed that "*No-one now contends that directors owe duties direct to shareholders*". Lord Reed and Lady Arden each noted that, roughly contemporaneously with the decision in *West Mercia*, Parliament introduced insolvency legislation which imposed liability on directors for wrongful trading and encouraged the rescue of distressed companies as an alternative to winding up. Lady Arden concluded that, far from being incompatible with it, the rule in *West Mercia*[1] worked harmoniously with the wrongful trading regime. The matter, she said, should not be left to Draconian remedies in a liquidation.

More recently, section 172 of the Companies Act 2006, which was considered in each of the judgments, introduced a statement of directors' duties. This requires them to have regard to the long-term consequences of their decisions, the employees of the company, relationships with suppliers, customers and others, the environment, the desirability of maintaining a reputation for high standards of business conduct and the need to act fairly between members.

Creditors are not, as such, mentioned in the list. But as Lord Briggs noted, employees and suppliers (he might have added customers) are likely to form important classes of a company's creditors. The majority, moreover, construed section 172 as a whole as affirming the existence of the rule in *West Mercia.* Lord Reed and Lady Arden felt unable to go that far but agreed that the creditor duty was entirely consistent with it.

The court found that it was no answer to say that shareholders are entitled to ratify breaches of duty by the directors. Lord Briggs traced the authorities right back to the foundational case of *Salomon v Salomon* [1897] AC 22 to conclude that the courts had always been careful to apply the ratification principle only to solvent companies.

The basis of the duty

The court made clear that the rule in *West Mercia* did not create a standalone duty owed to creditors, nor a right enforceable by them. Rather, it was an extension or adjustment of the directors' existing fiduciary duty to act in good faith in the interests of the company. It disapproved of the notion that creditors acquired a proprietary interest. Rather, there was a shift in economic interests when a company became insolvent. The risk transferred from the shareholders to creditors.

When the duty is triggered

In the Court of Appeal, David Richards LJ (with whom the others agreed) conducted a careful review of the English and Commonwealth authorities but was unable to find in them a clear answer as to when

[1]Lord Reed and Lady Arden referred to 'the rule in West Mercia'. The majority preferred 'the creditor duty,' although Lord Briggs used this "for want of a better label". The two formulations are used interchangeably in this note.

the creditor duty was triggered. He concluded that it was when insolvency was probable, *i.e.* more likely than not.

The Supreme Court agreed with the courts below that a real risk of insolvency was not enough. That was sufficient to dismiss the appeal but the Justices went on *obiter* to give further consideration to the point at which the duty was triggered. They disagreed with the Court of Appeal that it was a probability of insolvency.

Lord Reed pointed out that directors always had to be *mindful* of creditors as the payment of debts when they fall due is part of the conduct of a company's business. A company which did not pay its debts would suffer a loss of reputation and creditworthiness and eventually be unable to stay in business. Nevertheless, he added, it is unnecessary for them to consider creditors as a discrete aspect of the company's interests as long as the company remains financially stable.

The position changes if the company is insolvent or bordering on insolvency. As the surplus of assets over liabilities evaporates, the creditors as whole become persons with a distinct interest. Lords Reed and Briggs observed that insolvency need not be fatal or permanent. Lord Briggs gave as examples a start-up which was balance sheet insolvent but able to pay its bills as they fell due and the uncertainties facing hospitality businesses during lockdown.

At this stage, the director's duty to act in the company's interest has to the reflect the fact that shareholders and creditors each have an interest in the company's affairs. The directors must *have regard* to the interests of creditors as a body (not individual or particular creditors). The weight to be attached to creditors' interest will increase as the company's financial affairs worsen. Lady Arden was of the view that the duty at this stage extended to not materially harming creditors' interests by engaging in what she called 'insolvency-deepening' activity.

The position changes again when insolvency is inevitable[2], irretrievable[3], irreversible[4] or when there is no light at the end of the tunnel[5]. The majority framed the trigger as either imminent insolvency (an insolvency which directors know or ought to know is just round the corner and going to happen) or the probably of an insolvent liquidation or administration about which the directors know or ought to know. Lady Arden added a third scenario in which the directors contemplated a transaction which would bring about either of the other two.

Lord Reed doubted whether the knowledge requirement was an essential component, but it is not easy to see why liability should attach in circumstances where it cannot be said that the directors ought to have known of the position. Lady Arden suggested that the position might be that the onus is on the directors to show that they ought reasonably to be excused but preferred not to express a concluded view on the point.

At this stage, the court concluded, creditors' interests become paramount. Shareholders no longer have any interest in the company.

Directors' obligations to stay informed

Regardless of the disagreements about the knowledge requirement, the judgment makes clear that directors must keep themselves reliably informed about the company's financial affairs. Lady Arden framed it as a stark warning:

> *"The message which this judgment sends out is that directors should stay informed. The company must maintain up to date accounting information itself though it may instruct others to do so on its behalf. Directors can and should require the communication to them of warnings if the cash reserves or asset base of the company have been eroded so that creditors may or will not get paid when due.*

2 Per Lord Reed
3 Per Lord Hodge
4 Per Lady Arden
5 Per Lord Briggs

It will not help to resign if they remain shadow directors. In addition, directors can these days without much difficulty undertake appropriate training about their responsibilities, and about the penalties if they disregard them."

Application to lawful distribution

It was common ground that the distribution to Sequana was lawful under the statutory provisions regulating payment of dividends and the common law rules about maintenance of capital. The Respondents argued that, even if the rule in *West Mercia* were good law, it could have no obligation to a lawful distribution. The court unanimously rejected the argument.

CONCLUSIONS

This is an important decision for company directors and D&O insurers. It firmly embeds the creditor duty into English law and brings welcome clarity about when the duty will be triggered. It is also welcome that the Supreme Court has joined with the courts below in rejecting a real risk of insolvency as the trigger. This would surely have had a chilling effect on directors and discouraged the entrepreneurial risk-taking which the very concept of the limited liability company is intended to promote. However, the Supreme Court expressly left some questions open and this, and the differences of views expressed *obiter* by the Justices, means there remain issues to be worked out by the courts in subsequent cases.

Further Information

Given the generality of the note it should not be treated as specific advice in relation to a matter as other considerations may apply.

Therefore, no liability is accepted for reliance on this note. If specific advice is required, please contact one of the Partners at Caytons who will be happy to help.

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