Where do directors' duties lie once insolvency looms?

In *BTI 2014 LLC v. Sequana S.A.* [2022] UKSC 25, the UK Supreme Court handed down its judgment which examined the role of directors when a company becomes, or is likely to become, insolvent. The decision looked at when directors were to consider the overriding interests of the company's creditors when dealing with insolvency.

By Sam Dorne

Directors' duties and insolvency

When times are good the duty of a director is fairly simple. Indeed it is spelled out in section 172 of the Companies Act 2006, which states that a director must *act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*.

When times are bad, and insolvency beckons, the directors' duty turns to protect the creditors interests. Priority should not be given to any one creditor.

When exactly those interests turn can, however, not always be clear. The interest is supposed to turn when the directors knew, or should have known, that the company was likely to become insolvent. There can clearly be a grey area, and this was the subject of discussion in the *Sequana* decision.

Background

In the *Sequana* case, the directors of AWA paid a dividend of 135 million euros to its sole shareholder, Sequana. There was no issue with AWA's cash flow; however, it did have liabilities that were of uncertain value which *gave rise to a real risk, although not a probability, that AWA might become insolvent at an uncertain but not imminent date in the future*.[1]

Nine years later AWA became insolvent. BTI became the assignee of AWA's claims and sought to recover the 135 million euro dividend on the basis that the directors breached their duty to consider and act in the interests of AWA's creditors.

BTI was unsuccessful in both the High Court and the Court of Appeal. The Court of Appeal held that the duty to protect the creditors' interests may be triggered in circumstances short of actual insolvency, and in particular *when the directors know or should know that the company is or is likely to become insolvent*.

The Supreme Court

BTI made an appeal to the Supreme Court, which was dismissed. The Court held:[2]

> Where the company is insolvent or bordering on insolvency but is not faced with an inevitable insolvent liquidation or administration, 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

1 *BTI 2014 LLC v. Sequana S.A.* [2022] UKSC 25 at [115].

2 At 81.

company's affairs. 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, and act accordingly. Where their interests are in conflict, a balancing exercise will be necessary.

The Court went on to add that only where insolvency is inevitable do the creditors' interests become paramount.

In applying this approach to the facts, the Supreme Court found that at the time the dividend was paid the duty of the directors to protect the creditors was not engaged because AWA was not insolvent and there was nothing to suggest that insolvency was even likely to occur.

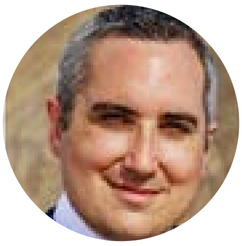
Conclusion

Directors must clearly keep a keen watch on the company's finances and liabilities, and if the company is insolvent or bordering on insolvency, but it is not inevitable that the company will fold, the directors will need to be able to show that they are balancing the interests of the company's creditors with the interests of its shareholders. Only where it is inevitable that insolvency will occur will the interests of the creditors become paramount when directors are exercising their decision-making duties.

Ultimately, the directors' fiduciary duty requires them to give consideration to creditors' interests in a manner that is appropriate to the circumstances of the company at the time, and must be balanced against the potentially conflicting interests of other stakeholders, including members.

Accordingly, directors must stay current with the company's affairs and regularly assess its financial position. The general principle is that the more the company has financial difficulties, the greater the weight and consideration that should be given to the creditors' interest.

About the author



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He recently returned to NZ after nearly 19 years of living in the UK where he spent the last several years working as a civil litigation solicitor mainly dealing with the recoverability of legal costs and consumer claim cases. He has experience in advocacy, case management and legal drafting and had several cases go to the Court of Appeal in England.