Sequana – What You Need to Know

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Summary

The Supreme Court has delivered its long-awaited decision in *BTI 2014 LLC v. Sequana S.A.* [2022] UKSC 25. It is a significant decision for the law of directors' duties. For the first time the UK's highest appellate court has considered the circumstances in which directors can be liable for failing to take into account the interests of creditors, thereby upholding the Court of Appeal's 2019 decision.[1] In doing so the Supreme Court affirmed a line of common law cases that have developed the law in this area and have held that directors are required to prioritise creditors' interests in an insolvent liquidation over those of shareholders, and to begin taking creditors' interests into account where insolvency "looms". The Court's unanimous decision is also noteworthy because it confirms the UK has definitively departed from the position in other common law jurisdictions – including Delaware and Canada – that have declined to impose an equivalent duty.

In summary, the Court confirmed that:

1. The duty to consider the interests of creditors is engaged when the directors know, or ought to know, that the company is insolvent or bordering on insolvency. "Insolvent" in this context means cash-flow or balance-sheet insolvency, in line with the statutory tests.

2. When an insolvent liquidation or insolvent administration is inevitable, then the directors must treat the interests of creditors as paramount.

In a move that will be welcomed by directors and practitioners alike, the Supreme Court **rejected** the argument that directors need to consider the interests of creditors merely when there is a real risk of insolvency. The Court preferred the formulation that imminent insolvency, or the probability of an insolvent liquidation (or administration), are sufficient triggers for the duty to consider creditors' interests.

Background

The facts of the case are complex – featuring environmental damage, acquisitions, and a series of transactions over a number of decades. The key transaction that sparked this litigation was a

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[1] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112.

decision taken by the directors of a company, Arjo Wiggins Appleton Limited (AWA) to pay a dividend to its sole shareholder, Sequana. When the dividend was paid AWA was solvent (on both a cash-flow and balance-sheet basis) and the directors' decision was supported by solvency statements.

However, at the time, AWA:

- was no longer trading;
- had contingent long-term liabilities relating to environmental clean-up costs; and
- had limited assets of uncertain value, being certain investment contracts, insurance policies, and a large intra-group receivable owed by Sequana.

Some years later AWA went into administration. BTI 2014 Plc (BTI) contended that the dividend should not have been paid, arguing that when AWA's directors resolved to pay the dividend, the directors owed a duty to AWA's creditors to consider their best interests given the financial position of AWA. This led to the "creditor duty" being considered in depth by the Court. (For context, BTI took an assignment of AWA's claim against the directors.)

In *Sequana* the Supreme Court considered, (i) the existence of the creditor duty, (ii) whether the ability to pay a dividend that is otherwise lawful is nonetheless subject to the duty, (iii) the substance of the duty, and lastly (iv) when the duty is engaged.

What is the creditor duty?

Directors of companies owe certain duties to the company they serve. The Companies Act 2006 codified these and put them on a statutory footing. A core duty is for directors to act in good faith to promote the success of the company for the benefit of its members (*i.e.*, its shareholders) as a whole. However, the interests of shareholders are not exclusive and a line of cases has developed the idea that company directors must also consider the interests of creditors of the company where the company encounters financial difficulties.[2] The duty is engaged in circumstances where a company is or is likely to become insolvent. In effect, it requires directors to conduct a balancing act between taking into account the interests of creditors and shareholders in undertaking corporate actions. That process involves an ongoing assessment of the company's financial position. As the company's solvency deteriorates, the interests of creditors must have more weight where they may conflict with shareholders' interests. By the time an insolvent liquidation or administration is inevitable, the interests of creditors will have become paramount, which timing aligns with the test for personal liability for wrongful trading set down in section 214 of the Insolvency Act 1986.

The existence of the creditor duty

It exists! The statutory rule that directors owe duties to the company for the benefit of its members is modified by the common law rule that they must take account of the interests of the company's creditors as a whole. Besides the common law authorities, section 172(3) of the Companies Act 2006 makes clear that the rule survived the codification of directors' duties in the 2006 Act.

[2] See e.g.: *Nicholson v. Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Kinsela v. Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722; *West Mercia Safetywear Ltd v. Dodd* [1988] B.C.L.C. 250; *Kalls Enterprises Pty Ltd v. Baloglow* [2007] NSWCA 191; *Bilta (UK) Ltd v. Nazir (No 2)* [2016] AC 1.

Unlike in the case of a solvent transaction, transactions undertaken in breach of a duty to creditors when the company is insolvent cannot be ratified by shareholders.

Is an otherwise lawful dividend to a shareholder subject to the creditor duty?

Yes. Just because a company has complied with the technical requirements for declaring and paying a dividend, does not mean such a decision cannot be in breach of the creditor duty. More than one of the justices gave the example of directors who declared a dividend at a time when the company was balance-sheet solvent (having distributable reserves as the statutory test for payment of dividends requires) but cash-flow insolvent as an instance in which bare compliance with the statutory tests would not insulate directors from liability.

> It was argued that the common law creditors' duty recognised in this case was inconsistent with the statutory scheme, specifically because creditors' interests were protected by the wrongful trading prohibition under section 214 of the Insolvency Act of 1986.
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> Lord Hodge provides a helpful illustration of the circumstances where the statutory basis for personal liability for wrongful trading under section 214 of the 1986 Act may be insufficient to protect the legitimate interests of creditors.
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> He posits a hypothetical in which: (i) A company has been unsuccessful and the capital of the shareholders has been lost through balance-sheet insolvency; (ii) the company's directors know or ought to be aware in the exercise of their duty of skill and care that a formal insolvency process is more likely than not; (iii) there is a prospect of avoiding the formal insolvency if the company were to undertake a particularly risky transaction; but (iv) the company's assets that remain and that would be put at risk by the transaction would be lost to its creditors if the gamble were to fail.
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> Lord Hodge points out that the shareholders would probably have nothing to lose from the adoption of the very risky transaction as a last roll of the dice because the likely alternative would be a formal insolvency from which they would receive nothing. A requirement that the directors consider and, if the facts of the particular case require it, give priority to the interests of the company's creditors in their decision-making in such circumstances appears to be a necessary constraint on the directors, he considers. Absent the "creditor duty", the directors would be required to exercise their skill and care to achieve the purpose set out in section 172(1) to the potential detriment of creditors.

Creditors' interests are those of the general body of creditors, not specific creditors with specific interests such as subordinated or contingent creditors.

When does the shift occur?

To understand when the duty is engaged, it is first important to understand what the Court said about when the shift *does not* occur. Importantly, the Supreme Court confirmed that the duty to consider creditors' interests is not engaged merely by a *real risk* of insolvency. This was considered too low of a threshold and likely to impose an impracticable burden on directors' decision-making processes.

The duty *will be* engaged from the point at which the directors know, or ought to know, that the company is insolvent or bordering on insolvency (on a cash-flow or balance-sheet basis). Thus, the duty can arise prior to actual insolvency. In these circumstances directors must balance the interests of a company's shareholders and the interests of the company's creditors as a whole. At this point in time shareholders can no longer ratify decisions.

When a company's financial position begins to deteriorate, directors will then be required to sharpen the focus on the company's financial affairs and the interests of the company's creditors. If things become so dire that it becomes apparent that an insolvent liquidation or administration is inevitable, then the directors must treat the interests of the creditors as paramount.

Takeaways for directors

Undoubtedly, there is a risk of getting caught in the semantic weeds when attempting to work out when the duty is engaged and what is required of directors. It is also clear that while the Supreme Court has helpfully given guidance to lawyers to describe the creditor duty, identifying when the shift occurs is not an exact science. As such, directors may still be asking what this decision means for them in their day-to day operations and questioning what has changed.

The first thing that we would flag to directors is that the decision *does not* relax or lessen the scope or content of their duties. Indeed, the Judgment includes the following helpful take-away for directors (see paragraph 304 per Lady Arden):

- *"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. 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."*

In short, not much has changed in terms of the practical guidance for directors. Board meetings should be held regularly, and more frequently if conditions worsen. Directors should hold discussions with key stakeholders and creditors, and consult specialist legal and financial advice, at the earliest possibility.

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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