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# The director's "creditors' interest duty" and dividend payments *BTI 2014 LLC v Sequana SA* [2019] 1 B.C.L.C. 347

**Andrew Bowen** *QC*

## Introduction

When and in what circumstances does the directors' duty to have regard to the interests of creditors arise when the directors are considering payment of an otherwise lawful dividend? In *Sequana* the claimant company BTI argued that directors owed a duty to consider the interests of creditors (the directors' "creditors' interest duty") in any case where a proposal involved a real, as opposed to a remote, risk to creditors. In rejecting that argument the Court of Appeal undertook an extensive review of the authorities and the relevant provisions of the Companies Act 2006 (the 2006 Act) in the context of claims brought against directors who had authorised the payments and against the recipient company as constructive trustee in a factually complex 32 day trial.

## The facts (much simplified)

The Lower Fox River in Wisconsin, USA, had been heavily polluted in the 1950s and was then subject to a complex and very expensive clean-up operation. Through a series of corporate acquisitions and asset transfers AWA (AWA later assigned its claim to BTI) was subject to contingent indemnity liabilities in respect of the clean-up costs. At the time of the dividend payment AWA was not carrying on any business and its only function was to run off its indemnity liability. Its only assets were a guaranteed investment contract to provide funds to pay for all aspects of the clean-up costs liability and a debt owed to it by the defendant, S. AWA's directors resolved to pay a dividend by way of set-off against a debt owed by S to AWA. The effect of the dividend payment was to reduce the debt but also to reduce the assets available to meet the indemnity liability. The judge at first instance noted that while the estimate of the indemnity liability had been made by the directors fully in compliance with their statutory duties, and in compliance with the applicable accounting standards, it was clear that the estimate could, in the future, prove to have been too small or too large. The directors had reflected that possibility by describing the liability as a "significant underlying risk that was difficult to control". The company's auditors in its "emphasis of matters statement" said that the valuation of the liability would depend on court rulings and negotiations in the future, the outcome of which was not certain at the date of the valuation and was not under the company's control. AWA's ultimate liability depended on "moving parts", namely several pieces of large-scale litigation in the US; if AWA's exposure to those moving parts deteriorated then it might not be able to absorb that liability from its assets.

The principal element of BTI's case was that the directors owed a duty to consider the interests of creditors in any case where a proposal involves a real, as opposed to a remote, risk to creditors and the duty was engaged because a real, as opposed to a remote, risk to AWA as a creditor was self-evidently involved in the payment of the dividend.

**The law**

The statutory codification of directors' duties in Ch.2 of Pt 10 of the 2006 Act, under the heading of "general duties of directors", includes a duty under s.172(3) to promote the success of the company for the benefit of the members as a whole, which is, in turn, 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".

Unlike other prescriptive statements of duty ("a director of a company must act … ") s.172(3) merely refers to "any … rule of law requiring directors … to consider or act in the interests of creditors" without stating the circumstances in which the requirements comes into play.

The recognition at common law that consideration of the interests of creditors could be an element in directors' duties is "remarkably recent". In *West Mercia Safetywear Ltd (in liquidation) v Dodd* [1988] B.C.L.C. 250 a director had caused money to be transferred between insolvent companies to reduce his personal liability as a guarantor of a company overdraft and the Court of Appeal held that when a company was insolvent the interests of creditors intruded on the interests of shareholders and they became prospectively entitled through the mechanism of liquidation to displace the power of shareholders and directors to deal with the company's assets. The shareholders of an insolvent company could not ratify the acts of directors taken in disregard of creditors' interests because the insolvency means that the company's assets are, in a practical sense, the creditors' assets pending its liquidation or return to solvency. First instance decisions such as *Facia Footwear Ltd (in admin) v Hinchcliffe* [1998] 1 B.C.L.C. 218 have seen the duty arise where the company was insolvent or of "doubtful solvency" or "on the verge" of insolvency so that creditors are at risk. In *Bilta (UK) Ltd (in liquidation) v Nazir* [2016] A.C. 1, the Supreme Court confirmed the test of "insolvent or bordering on insolvency", at [123].

**The First Instance (Rose J) and the Court of Appeal decisions**

The parties had agreed that the effect of s.172(3) was to retain the common law principles as to when the duty arose, that the duty was owed to the company and not to creditors, that there was a single threshold for when the duty arose for all decisions taken by directors, that the content of the duty did not vary according to the degree of insolvency and that a failure to have regard to creditors' interests was not of itself a breach of duty if the directors could have reasonably concluded that the proposal should be approved even if creditors' interests were taken into account. The parties had also agreed that the duty could arise in circumstances where the company was not actually insolvent but differed over how close to insolvency the company had to be; S argued that it had to be very close while BTI argued that a real, rather than a remote, risk was enough. The source of BTI's argument was a series of Australian cases where the phrase "a real, as opposed to a remote, risk of insolvency" had been used.

In rejecting BTI's argument on s.172(3), Rose J described the difference in emphasis as between saying that "my house is on the verge of burning down" and "there is a risk which is more than a remote risk of my house burning down", with the former being "much more worrying"; so a test set at a level of "a real rather than a remote risk of insolvency" set a much lower threshold than a test set at the level of "on the verge of insolvency" or of "doubtful" or "marginal" solvency, at [121]. She found that the authorities did not establish that when a company was at risk of becoming insolvent at some indefinite point in the future then the creditors' interest duty arose unless the risk was remote. She also held that AWA could not be described as on the verge of insolvency or of doubtful insolvency because it faced a risk that in the future that it would have insufficient assets to meet a liability since that was a risk faced by many companies that had provisions and contingent liabilities reflected in their accounts; it would be a significant inroad into the normal application of directors' duties to have to take account of creditors' rather than shareholders' interests over an extended period and also a significant lowering of the threshold, at [122].

The Court of Appeal (David Richards LJ giving the judgment, Henderson and Longmore LJJ in agreement) noted that BTI submitted that the test should be triggered at the time when it could be said that the creditors had a sufficiently strong stake in the conduct of the company's business and activities when there was a real risk that a decision of the directors to pursue a particular course might lead to insolvency. That had to be balanced against the fact that the structure and wording of s.172(3) implicitly recognised that a precise statement of the trigger for the creditors' interest duty was difficult, at [202]. The intention behind s.172(3) was that the normal rule that a company was to be run for the benefit of its members would be displaced when the company was insolvent or nearing insolvency and the directors had to have regard to the interest of creditors.

David Richards LJ considered that there were four possible answers to the question of when the creditors' interest duty was triggered: first, when the company was actually insolvent either on a cash flow or balance sheet basis; secondly, when on the verge of, or nearing or approaching, insolvency; thirdly, when the company is or is likely to become insolvent or of dubious solvency; and fourthly, a real, as opposed to a remote, risk of insolvency. In his view, the fourth alternative was a significantly lower threshold than the second or third and was not part of the present law. While the duty could be triggered when a company's circumstance fell short of actual insolvency the first instance decisions used a variety of expressions rather than a single form of words because the precise moment at which a company became insolvent was often difficult to pinpoint because it could occur suddenly or gradually, at [218]. The appeal was refused on this basis. In addition, the court rejected the argument that the judge has decided the case on the basis that the risk was far in the future since the decision was centred on the degree of risk and not of timing.

Although David Richards LJ considered whether, once the creditors' interest duty was engaged, their interests were paramount or to be considered without being decisive, he expressed no view, merely saying that where the directors knew or ought to have known that the company was actually insolvent, it was hard to see that creditors' interests could be anything but paramount, at [222].

**Conclusion**

The decision provides useful guidelines for those advising directors on managing future risks in the context of current trading. However, the facts were unusual and probably of limited application to ordinary corporate decision-making. The decision also requires closer scrutiny because the judge did find that the dividend payment constituted a transaction defrauding creditors under s.423 of the Insolvency Act 1986.