The Position of Directors of Financially Distressed Companies

*By Jonathan Lawrence and Clare Tanner**

The authors review a decision by the Supreme Court of the United Kingdom that considers if and when directors of a financially distressed company incorporated in England and Wales have a duty to consider, or to act in accordance with, the interests of the company's creditors (the creditor duty) rather than in the interests of its shareholders.

The Supreme Court of the United Kingdom has delivered its long awaited judgment in *BTI v Sequana*.[1] It considers if and when directors of a financially distressed company incorporated in England and Wales have a duty to consider, or to act in accordance with, the interests of the company's creditors (the creditor duty) rather than in the interests of its shareholders.

BACKGROUND

The appeal arose from the distribution of a €135 million dividend by Arjo Wiggins Appleton Ltd. ("AWA") to its only shareholder Sequana SA in 2009. The dividend was lawful in that it complied with the statutory scheme regulating payment of dividends and with common law rules about maintenance of capital. At the time the dividend was distributed, AWA was solvent on both a balance sheet and cash flow basis.

However, the company was facing considerable long-term pollution related contingent liabilities.

These liabilities, of an uncertain amount, together with uncertainty as to the value of AWA's insurance portfolio gave rise to a real risk of insolvency at an uncertain but not imminent date in the future.

AWA went into administration in October 2018. AWA's assignee BTI 2014 LLC sought to recover an amount equal to the 2009 dividend from AWA's directors personally on the basis that the decision to distribute the dividend was a breach of the creditor duty.

DOES THE CREDITOR DUTY EXIST?

The Supreme Court affirmed the existence of a common law creditor duty[2] which, in certain circumstances, modifies a director's duty to promote the success of the company for the benefit of shareholders.[3] The creditor

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duty is not freestanding rather it is a modification of the duty which the directors owe to the company.

WHEN IS THE CREDITOR DUTY TRIGGERED?

BTI argued that the creditor duty is triggered where there is a real risk of the company entering into insolvency. The Supreme Court disagreed and decided, obiter, that the creditor duty is triggered where:

1. The company is insolvent or insolvency is imminent; or
2. Entry into insolvent liquidation or administration is probable.

Further, the majority decided that the creditor duty is engaged when the directors know or ought to know that the company is insolvent or insolvency is imminent or that an insolvent liquidation or administration is probable. The minority left open the question of knowledge.

WHAT IS THE CONTENT OF THE CREDITOR DUTY?

The Supreme Court decided that when the company is insolvent or insolvency is imminent, the creditor duty is a duty to consider creditors' interests, to give them appropriate weight, and balance them against shareholder interests where they may conflict. As a general rule, as the financial situation of the company worsens, greater weight should be given to the interests of creditors.

Where an insolvent liquidation or administration is inevitable, the interests of creditors become paramount. This is because the shareholders cease to have any economic interest in the company.

While a "sliding scale" approach to balancing shareholder and creditor interests may reflect the economic reality of a financially distressed company, the analysis remains fact sensitive and Lord Briggs noted that:

> Much will depend upon the brightness or otherwise of the light at the end of the tunnel; i.e. upon what the directors reasonably regard as the degree of likelihood that a proposed course of action will lead the company away from threatened insolvency, or back out of actual insolvency.

Where directors are under a duty to act in good faith in the interests of creditors, shareholders cannot authorize or ratify a transaction which is in breach of that duty.

CONCLUSION

The judgment provides some clarification as to the existence and content of the creditor duty and the circumstances in which it is triggered. However, the fact sensitive nature of the analysis is such that directors in this position should take early professional advice on their particular circumstances.

NOTES:

[1]BTI 2014 LLC (Appellant) v. Sequana SA and others (Respondents) [2022] UKSC 25.

[2]West Mercia Safetywear Ltd v. Dodd [1988] BCLC 250.

[3]Section 172 Companies Act 2006.