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BTI v Sequana: directors must continue to be aware of creditors' interests on the road to insolvency

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In the earlier decisions in this case the English High Court and Court of Appeal considered the question: does the duty to act in the best interests of the company require directors to consider and act in the interests of the company's creditors, rather than the shareholders, only when the company becomes insolvent or even before insolvency? If before, at what point in the period when a company approaches, or is at real risk of, insolvency does that duty arise? What is the applicable test?

The duty to take account of creditors' interests - the leading case of *West Mercia*

It is trite law that a director's fiduciary duty to act in good faith in the interests of the company is owed to the company as a whole, not to its stakeholders individually. Historically, the interests of the company has meant the interests of its shareholders as a whole.

In *West Mercia Safetywear Ltd (in liquidation) v Dodd* [1988] BCLC 250 the English Court of Appeal (applying Antipodean caselaw) accepted for the first time that, once a company is insolvent, the interests of creditors override those of the shareholders since the company's assets practically belong to the creditors who can displace the power of the shareholders and directors to deal with the assets. The creditors effectively become the real stakeholders of the company, entitled to the company's assets on its winding up, whereas the shareholders no longer have any real economic interest in the company. Even though creditors always have an economic interest in the company indebted to them, the significance of that interest grows when a company becomes insolvent or is likely to become insolvent, and the directors' duty to consider those interests should grow accordingly.

Although referring to a "creditor duty" the case did not create a new freestanding duty owed to creditors, but recognised that at the point of insolvency the company's best interests meant the interests of the creditors, which were not necessarily aligned with the interests of the shareholders.

BTI v Sequana - the earlier decision

The directors of AWA caused it to distribute a €135m dividend to its sole shareholder, Sequana. At the time AWA was solvent on a balance sheet and cash flow basis but had long term contingent liabilities of an uncertain, but likely substantial, amount. Even though insolvency was not imminent, or even probable, there was a real risk that AWA might become insolvent in the future.

AWA ended up in insolvent administration and BTI, assignee of AWA's claims, alleged that the dividend had been paid to Sequana in breach of the directors' duties to consider and act in the creditors' interests, those interests representing the interests of AWA at that time given its real risk of future insolvency.

The Court of Appeal dismissed BTI's allegation. The Court rejected the suggestion that the duty to have regard to the interests of creditors arose when there was a real, as opposed to a remote, risk of insolvency. They concluded that such a test was too vague and uncertain and acknowledged that the English courts had shied away from a simple formulation directing when the creditor duty would arise.

The Court of Appeal did agree that the duty to consider creditors' interests could be triggered even when a company's circumstances fell short of actual insolvency. It found that such a duty arises when the directors know or should know (thereby adding an element of objectivity) that the company is or is likely to become insolvent. In that context, the Court of Appeal considered that "likely" meant probable. The creditor duty therefore arose if the company was actually insolvent, on the brink of insolvency or probably headed for insolvency. As such, the factual matrix was crucial.

On the facts of the case, as AWA was solvent on a balance sheet and cash flow basis, but had long term contingent liabilities, the Court of Appeal determined that even though there was a real, not remote, risk of insolvency in the future, it was neither imminent nor probable at the time of the dividend payment. It said there was therefore no duty owed to creditors at that time.

The Supreme Court decision - upholding the principle

On appeal from this decision the Supreme Court had to decide (among other things) whether the trigger for the common law duty to take into account creditors' interests is merely a real risk of, as opposed to a probability of or close proximity to, insolvency and whether the application had survived the codification of directors' duties in the Companies Act 2006, including the doctrine of shareholder ratification. The Supreme Court justices affirmed unanimously that such a change in focus does exist (and was affirmed or preserved by the Companies Act 2006) and once applied any breaches could not be ratified by a decision of the shareholders. The Court was split on the question of the point at which that change would arise, recognising the linear nature of the progress towards insolvency and that on the road to insolvency there would be a point when the interests of both sets of stakeholders would be in conflict and need to be balanced. The majority held that the duty towards creditors was engaged when the directors knew or should have known that the company was insolvent or bordering on insolvent, or that an insolvent liquidation or administration was probable, with the minority leaving open the question of whether it was essential that the directors knew or ought to have known that to be the case. However, the Court unanimously held that the duty was not engaged on the facts of the case as AWA was not actually or imminently insolvent, nor was insolvency even probable, and accordingly dismissed the appeal.

Application in the offshore courts

Although director duties have not been codified in most of the offshore jurisdictions, the concept of a duty to take into account creditors' interests has long been recognised in the offshore courts and is supported by the various provisions relating to antecedent transactions seeking to restore assets to an insolvent company, and the *BTI v Sequana* Court of Appeal summary has been seen as a reflection of the existing legal position in the offshore jurisdictions.[1]

The test upheld by the Supreme Court is therefore likely to be applied when such questions come before the offshore courts in the future.

In carrying out their duties directors should ensure that they remain informed of the company's financial position at all times, taking into account factors that may impact the solvency status of the company, including contingent liabilities. If the company is insolvent or bordering on insolvent the directors must take into account the interests of the creditors (as a whole), even if an insolvency process is not inevitable, balancing their interests against the interests of the shareholders where they may conflict. The path to insolvency will likely not be linear and the greater the financial challenges the company faces, the greater the weight that the directors must give to creditor interests. A shareholder resolution will not be a panacea and factors supporting directors' decisions are likely to be scrutinised. It is therefore as important as it has ever been for directors to seek legal advice at an appropriate time and fully document their decision-making processes.

Read the Supreme Court's press summary: BTI 2014 LLC (Appellant) v Sequana SA and others (Respondents) - Press Summary (supremecourt.uk)

[1] See for example the Cayman Islands Court of Appeal decision of *AHAB v Saad* 21 December 2021, CICA NO. 15 of 2018

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