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doi:10.1017/S0008197323000120

CREDIT WHERE CREDIT'S DUE: THE SUPREME COURT TAKE ON DIRECTORS' DUTIES AND CREDITORS' INTERESTS

MASON J.'s dictum in the 1976 decision of the High Court of Australia in *Walker v Wimborne* [1976] 137 C.L.R. 1 (at [6]–[7]) stated: "the directors of a company in discharging their duty to the company must take into account the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them." Ever since, creditors' interests potentially impacting directors' duties during the "twilight zone" of insolvency has been a subject of interest. The theme has had many renaissances since its precursor case, with the latest being the Supreme Court's decision in *BTI 2014 L.L.C. v Sequana S.A. and others* [2022] UKSC 25. While the ruling confirms and clarifies various aspects of the rule in *West Mercia Safetywear Ltd. v Dodd* [1988] BCLC 250 including that there is no independent duty owed to creditors and that creditors must be considered as a general body, questions such as the level of knowledge required of directors to trigger the duty remain unclear.

In 2009, AWA – which was solvent at the time – distributed a €135 million dividend to Sequana, its sole shareholder. The distribution complied with the capital maintenance rules and requirements of the Companies Act 2006 (CA 2006). However, AWA had long-term environmental contingent liabilities, the levels of which had merely been estimated, meaning that there was a risk AWA could become insolvent, even if it was not likely at that point in time. Owing to an underestimation of those liabilities, the risk did materialise and AWA went into insolvent administration in 2018. BTI, as assignee of AWA's claims, sought to recover the 2009 dividend. BTI argued that, in accordance with the common law, creditors' interests had intervened at the time of the distribution, modifying the directors' usual duty to act in good faith to promote the success of the company for the benefit of its members as a whole under CA 2006, s. 172. The dividend prejudiced AWA's ability to repay its creditors, and, therefore, the board ought not to have authorised its payment.

Both the High Court and the Court of Appeal rejected BTI's claim. David Richards L.J., in the Court of Appeal ([2019] EWCA Civ 112), canvassed four potential company circumstances when the need to consider creditors' interests may be triggered: (1) upon actual insolvency; (2) on the verge of insolvency or nearing insolvency; (3) when insolvency is more likely than not; and (4) when there is a real – as opposed to remote – risk of insolvency. David Richards L.J.

https://doi.org/10.1017/S0008197323000120 Published online by Cambridge University Press

(with whom Longmore L.J. and Henderson L.J. agreed), applying the third trigger, argued that "the duty arises when the directors know or should know that the company is or is likely to become insolvent". Rejecting the fourth trigger, he stressed that even a real risk of insolvency in the future was insufficient unless its crystallisation was likely. Accordingly, the Court of Appeal held that AWA's directors had not breached their duty, as the company was not likely to become insolvent when the dividend was paid in 2009. BTI obtained leave to appeal to the Supreme Court, which had to address whether a common law duty to consider creditors' interests existed at all; when the duty was triggered; and the content of such a duty (including whether that duty could apply to a decision to pay an otherwise lawful dividend).

The starting point for the court in *BTI v Sequana* was the rationale for the existence of a possible duty. Ever since *Walker v Wimborne*, *Nicholson v Permakraft (NZ) Ltd.* [1985] 1 N.Z.L.R. 242, and *Brady v Brady* [1989] A.C. 755, there have been concerns over directors' conduct in the face of company insolvency when the interests of shareholders and creditors could conflict. In *Kinsela v Russell Kinsela Pty Ltd. (in liq)* [1986] 4 N.S.W.L.R. 722, Chief Justice Street established that it is creditors' funds, not shareholders' funds, that are at risk in such circumstances. A creditor-oriented duty-shifting rule would prevent companies from externalising the costs of their debts by deploying the company's assets in high-risk endeavours when insolvency was approaching. Such sensibilities were also germane when Parliament enacted CA 2006, s. 172(3), which subjects the general duty under section 172 to any rule of law requiring directors to consider the interests of creditors. Relying on past case law – especially *West Mercia* – the Supreme Court affirmed the requirement, in some circumstances, to consider creditors' interests. However, addressing long-standing scholarly debates (for example, S. Worthington, "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 Melbourne University Law Review 121, and P. Davies, "Directors' Creditor – Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 European Business Organization Law Review 301), the court unanimously confirmed that no independent duty is owed to the creditors, and that the requirement to consider creditors' interests is a manifestation of the duty owed by directors to the company under section 172, widening the scope of interests that should be taken into account when considering the company's interests. This approach is in line with precedents such as *Yukong Lines of Korea v Rendsburg Investments Corporation of Liberia* [1998] EWCA Civ 911 and the Australian High Court in *Spies v The Queen* [2000] HCA 43, and it represents a long-awaited clarification of the doctrine.

The trigger point for the duty and its content have been other areas of significant uncertainty. In relation to the trigger, although it is clear from

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cases such as *Bilta (UK) Ltd. (In Liquidation) v Nazir* [2015] UKSC 23 that creditors' interests can intervene before actual insolvency, formulations on the threshold varied. Prior to *Sequana*, terms such as "near insolvency", "doubtful solvency", "in a dangerous financial position or on the verge of insolvency", "parlous financial state" and "in financial difficulties" were regularly used throughout the case law. When the trigger is set is a contentious aspect of scholarship, with academics such as Sealy and Cheffins highlighting that a core director's function is making business judgements and taking risks. Setting the trigger too early could impinge upon the board's ability to turn-around a company in financial difficulties. As for the duty's content, prior to the decision in *BTI*, the case law was unclear as to whether, once the duty had been triggered, creditors' interests were paramount or whether they were to be considered alongside the interests of shareholders.

The Supreme Court has now provided some clarity on the trigger and the requirement's content. The majority described the threshold as when "the directors know, or ought to know, that the company is insolvent or bordering on insolvency or that an insolvent liquidation or administration is probable" (at [203], [207], [231], [247]). The minority agreed that the duty is triggered when the company is "insolvent or bordering on insolvency", but declined to opine on whether "knowledge" on the part of the directors is essential, since the point was not required to be decided on the facts. Accordingly, the court rejected BTI's appeal since the company was neither insolvent nor bordering on insolvency at the time the dividend was paid. The court also considered the requirement's content, confirming that creditors' interests become paramount over shareholders' interests if insolvency is inevitable, with a "sliding scale" applied before that – once the requirement is triggered, the weight given to creditors' interests increases as the financial situation worsens. The court additionally confirmed that creditors must be considered as a general body, and, *obiter*, that the duty can be triggered in the context of a distribution even if that distribution is lawfully made in accordance with the requirements of CA 2006.

The Supreme Court's decision marks a clear departure from previous case law by rejecting instances where there is a risk of insolvency, or even, per the Court of Appeal decision, "where the company is likely to become insolvent", as too low thresholds. Boards will welcome the decision since it should give them leeway to attempt to rescue a struggling company. The court's approach resonates with the hallmarks of UK company law, avoiding excessive caution early in a distress situation (all the more relevant in recent years of compounding crises). However, questions remain. First, the level of knowledge required of directors to trigger the duty is still uncertain. Second, although clearly creditors' interests prevail when insolvency is inevitable, personal

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liability will still weigh heavily on the minds of directors during the period prior to "inevitable insolvency", when a nebulous "sliding scale" seemingly applies and creditor and shareholder interests must be "balanced". Finally, when the requirement has been triggered, having to consider the interests of the creditors as a general body can create challenges when, for example, directors borrow new money to pay-off old money. Given that creditors are often not a homogenous group and may have conflicting interests, it may be unclear how directors should proceed in such a situation. Overall, the court's decision appears to promote a "rescue culture", but, even so, the sagacity of some forms of restructuring might still be uncertain.

As noted by Lady Arden, the Supreme Court's decision is a "momentous… decision for company law" (at [248]). Indeed, the decision has clarified many grey areas and will be welcomed in some circles as giving directors the flexibility they need to manage companies in times of strife. However, gaps and uncertainties remain, and further case law will be necessary to put flesh on the bones of the court's decision.

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https://doi.org/10.1017/S0008197323000120 Published online by Cambridge University Press