Directors' duty to act in the interests of creditors under section 172 of the Companies Act 2006 – Aussie Rules Gone Walkabout

BTI 2014 LLC v Sequana SA and others [2019] EWCA Civ 112

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I. INTRODUCTION

Sections 171 to 177 of the Companies Act 2006 ("the Act") codified the duties owed by directors to their companies in equity and at common law. Section 170(4) of the Act states that the codified duties: "shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties."

The principles and rules underpinning directors' duties are generally fully addressed in the case law preceding the codification by the Act. The case law rules adopted by the Act's codification are reasonably well developed in all areas of directors' duties. A significant exception to this is the uncertainty surrounding the duty of directors to take account of the interests of creditors once a company becomes (or is close to becoming) insolvent. In giving the judgment of the Court of Appeal in *BTI 2014 LLC v Sequana SA and others* [2019] EWCA Civ 112 ("*Sequana*"), David Richards LJ has provided very clear guidance on the operation of this duty and clarifies how and when the duty arises.

Section 172 codifies what was formerly usually referred to as the fiduciary duty owed by a director to act *bona fide* in the best interests of the company. The statutory version of the duty states that a director must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members (shareholders) as a whole. In doing so, the director must have regard to a number of matters such as the long term effects of decisions, the interests of employees and the impact on the community and the environment.

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The duty to promote the success of the company is amended in circumstances where the company is insolvent or threatened by insolvency. In such circumstances, the duty owed by the director shifts from one owed to the company, taking into account what would be in the best interests of its members, to one owed to the company taking into account the interests of its creditors. Once a company is insolvent its members are no longer able to benefit from the company's assets. The assets are instead held for the benefit of the company's creditors.

Section 172(3) states that the duty to promote the success of the company is subject to any rule of law which requires directors, in certain circumstances, to consider or act in the interests of creditors of the company. There has been a good deal of uncertainty as to when the duty to take into account the interests of creditors is triggered. This aspect of the duty is explained in *Sequana*.

II. FACTS

Dividends were paid when a company, AWA, had ceased to trade. AWA had one material outstanding contingent liability involving the uncertain clean-up costs arising out of a river pollution action in the USA. The majority of AWA's assets consisted of an inter-company debt of €585 million owed to AWA by its parent company, Sequana. The dividends in question were authorised by AWA in favour of Sequana. A dividend, once authorised, becomes a debt enforceable at law. Instead of paying the dividends in cash, AWA set off the amount of the dividends against Sequana's debt (effectively extinguishing the parent company's liability to AWA). One of the purposes of the dividend payment was to prevent the money owed by Sequana being called in by AWA and used to cover the potentially enormous costs of its liability for river pollution.

The case concerned an attack on the validity of the dividends paid by AWA to Sequana. The dividends, which had been legally authorised by AWA's directors, were challenged on the basis: 1) that they were made with an intention to defraud creditors under section 423 of the Insolvency Act 1986; and, in the alternative, 2) that they were paid in breach of duty by the directors of AWA to have regard to the interests of AWA's creditors. In the High Court, the first ground succeeded but the second failed.

III. DECISION

The Court of Appeal upheld the first instance decision.

Sequana is significant for its explanation of the directors' duty to have regard to the interests of creditors but it also clarifies and recognises a new situation where section 423 of the Insolvency Act 1986 is capable of operating. This note will not consider in any detail the section 423 point but will concentrate on the exposition of section 172(3).

a) Section 423

The dividends were legally valid under Part 23 of the Companies Act 2006 (which deals specifically with the rules for the legality of a dividend) mainly due to how a company's annual accounts deal with valuing and making allowances for contingent liabilities. The payment of the dividends was nevertheless found to fall foul of section 423 of the Insolvency Act 1986. It was held to be a transaction at an undervalue where AWA had taken steps to put assets (the Sequana loan) beyond the reach of its creditors (present and future). AWA had received no consideration for the dividends, the payment fell within the broad definition of a transaction and AWA had paid the dividends with the purpose (which need not be the sole or dominant purpose) of putting monies beyond the reach of its creditors. The Court of Appeal upheld the first instance judgment that Sequana was liable to repay an amount up to the value of the dividend, that is, an order under section 423(2) which restored "the position to what it would have been if the transaction had not been entered into."

b) Creditors' Interests Duty

The appellants' second argument was based upon the proposition that directors owe 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. They claimed the duty had been triggered and breached on the facts of the case.

In order to assess the nature and extent of a director's duty owed to creditors, David Richards LJ, in a very clear and considered judgment[1] explained the historical development of what was referred to as "the creditors' interests duty". His Lordship confirmed the comments of Rose J at first instance that:

1) section 172(3) retains the common law principles as to when the duty arises;

2) the duty is owed to the company not the creditors;

3) there is a single threshold for when the duty arises for all decisions taken by directors;

4) the content of the duty does not vary according to the degree of risk of insolvency; and

5) a failure to have regard to the interests of creditors is not 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.

c) It comes from a Land Down Under

His Lordship explained that the common law requirement to take into consideration the interests of creditors is of a fairly recent vintage. It first appeared in the Australian High Court in *Walker v Wimborne*[2] where it was observed that a creditor's interests must be taken into account where a company is insolvent. In the UK, *obiter dicta* a few years later by Templeman LJ in *Re Horsely & Weight Ltd*[3] seem to extend this basic principle by suggesting that misfeasance or a "fraud on the creditors" may be perpetrated where a company expends money it could not afford in circumstances where the company is "doubtfully solvent".

The only previous applicable Court of Appeal authority was that in *West Mercia Safetywear Ltd v Dodd*[4] in which Dillon LJ held a director to be in breach of duty when, for his

[1] The judgment is extremely erudite and his Lordship makes a number of helpful and interesting observations. For example, at [151] his Lordship considered that judicial opinions describing the use of limited liability as a privilege, were mistaken: "In English law, the right to form and a register a company under the Companies Act is, in no sense, a privilege. It is a right conferred by statute in unqualified terms, and it is a right that Parliament created over 170 years ago in the public interest and for the purpose of advancing the economic well-being of the country. In any event, the right is conferred on those who form a company, the shareholders, while the duty under discussion is one imposed on directors who, as in the present case, may well not be the shareholders."

[2] (1975-1976) 137 CLR 1.

[3] [1982] Ch 442.

[4] [1988] BCLC 250.

own purposes, he made a transfer of money "in disregard of the interests of the general creditors of this insolvent company". *West Mercia* established two propositions: 1) the members of an insolvent company cannot ratify the acts of directors taken in disregard of the interests of creditors and so the directors of an insolvent company must have regard to those interests; and 2) where the company is insolvent, its assets are in a practical sense the assets of the creditors.

In addition to the above, the Court in *Sequana* considered a number of subsequent Commonwealth authorities where it had been said in *obiter dicta* that the creditors' interests duty arises "if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency" (per Cooke J in *Nicholson v Permakraft (NZ) Ltd*[5] a statement later approved by Street CJ in *Kinsela v Russell Kinsela Pty Ltd (in liq)*[6]).

A number of English first instance decisions were also considered by the Court of Appeal. In particular, *Facia Footwear Ltd v Hinchcliffe*[7] where it is suggested, again *obiter*, that the duty to take into account the interests of creditors arises where the company is "in a very dangerous financial position" or is in a "parlous financial state". In *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*[8] the duty was said to arise when the company "is insolvent or of doubtful solvency or on the verge of insolvency and it is the creditors' money which is at risk". To similar effect in *Re MDA Investment Management Ltd*,[9] the duty was said to arise "when a company, whether technically insolvent or not, is in financial difficulties to the extent that its creditors are at risk".

In *Bilta (UK) Ltd v Nazir*[10] the Supreme Court commented that the common law treated "the interests of an actually or prospectively insolvent company as synonymous with those of its creditors" and the duty to have regard to the creditors' interests arises where the company is "insolvent or bordering on insolvency".

These UK authorities provide some support for the proposition that something short of actual, or established, insolvency will be sufficient to trigger the creditors' interests duty but none of the English cases provides any support for a test which looks for "a real as opposed to a remote risk of insolvency".

d) Vegemite or Marmite? Like it not they are not the same thing

A number of other Australian cases adopted the test for the trigger of the creditors' interests duty to be "a real, as opposed to a remote, risk of insolvency".[11]

Back in the UK, in *Vivendi SA v Richards*,[12] Newey J cited with approval such Australian authority. Newey J regarded the test of a real as opposed to a remote risk to creditors as being "to similar effect" as the test of "insolvent or of doubtful solvency or on the verge of

[5] [1985] 1 NZLR 242.
[6] (1986) 4 NSWLR 722.
[7] [1998] 1 BCLC 218.
[8] [2002] EWHC 2748 (Ch), [2003] BCC 885.
[9] [2003] EWHC 2227 (Ch), [2004] 1 BCLC 217.
[10] [2015] UKSC 23, [2016] AC 1.
[11] *Grove v Flavel* (1986) 11 ACLR 161, *Kalls Enterprises Pty Ltd v Baloglow* [2007] NSWCA 191 and *The Bell Group Ltd v Westpac Banking Corporation* [2008] WASC 239, 70 ACSR 1 (Owen J) and [2012] WASCA 157, 89 ACSR 1 (Western Australia Court of Appeal).
[12] [2013] EWHC 3006 (Ch), [2013] BCC 771.

insolvency”. The same view was taken in *Re HLC Environmental Projects Ltd*[13] where the court did “not detect any difference in principle behind these varying verbal formulations”.

David Richards LJ in *Sequana* did not view the tests as being the same thing expressed differently. They are different tests. A real, as opposed to a remote, risk of insolvency can arise even though the company is not insolvent and may very well never become insolvent. Although his Lordship did not expand upon this point it is clearly the case that many companies, often throughout their entire existence, operate where there is a real risk of insolvency. It is indeed the function of directors to take commercial risks in order to make a profit. A company facing a real risk of insolvency is not necessarily one where its demise is imminent or even likely. The test laid down in the Commonwealth cases therefore sets a less demanding test than one where the company is likely to become insolvent. It arguably encourages directors to be overly cautious. It perhaps makes more commercial sense for a director to be able to continue to take commercial risks where there is a real risk of insolvency but to stop doing so, and begin to act in the interests of creditors, once the company’s insolvency is likely (that is, more likely than not).

e) Strewth – not True Blue Aussie!

As well as considering the UK and Commonwealth case law, David Richards LJ considered in detail the UK legislative and law reform history of section 172 as well as other legislative provisions considering the meaning of solvency.

His Lordship concluded that there were at least four possible answers to the question of when the creditors’ interests duty is triggered:

1) it may be only when the company is actually insolvent, either on a cash-flow or balance sheet basis;

2) it may arise when the company is on the verge of insolvency or nearing or approaching insolvency;

3) it may arise when the company is likely to become insolvent (which his Lordship interpreted as what judges mean when they refer to a company as being of dubious solvency); or

4) it might, consistently with the Australian and other Commonwealth authorities, be where there is a real, as opposed to a remote, risk of insolvency.

Such phrases as the company being in a parlous financial state or in financial difficulties, could fall within either category 2) or 3). Although such words of description may accurately reflect the situation in any given case they were too vague to form a useful test for the trigger moment for engaging the creditors’ interests duty.

His Lordship was very clear to point out that the tests in category 2), 3) and 4) were different and not merely alternative ways of saying the same thing. A real as opposed to a remote risk of insolvency is a significantly lower threshold than being either on the verge of insolvency or likely to become insolvent. Category 4), based upon Commonwealth authorities, did not form part of the present UK law as regards the creditors’ interests duty. It was not

[13] [2013] EWHC 2876 (Ch), [2014] BCC 337.

appropriate (considering both policy considerations and other provisions of the Companies Act) for the courts to introduce such a test as a development of the common law.

The Court concluded that actual insolvency (category 1 above) was enough for the duty to be triggered but was not the only threshold for the duty to be engaged. Directors may not know, nor be expected to know, that a company is in fact insolvent until sometime later. A test falling short of established insolvency is therefore justified.

The problem identified with category 2) was that it used phrases such as being "on the verge of insolvency", which suggests a temporal test. If the test is that insolvency is "imminent", or if similar words are used, it suggests that actual insolvency will be established within a very short time. It does not cover the situation where, although the company may be able to pay its debts as they fall due for some time, insolvency is nonetheless likely to occur with the result that decisions taken by directors now may prejudice creditors.

His Lordship therefore discounted category 2) and adopted category 3). The test for when the duty is triggered is therefore when the directors know or should know that the company is or is likely to become insolvent. In this context, "likely" means probable.

On the facts of the case, there was nothing to suggest that at the time of the dividends being authorised that AWA was insolvent or was likely to become insolvent. The trigger for the duty had not occurred.

IV. FAIR DINKUM

Although the creditors' interests duty originated in Australia, the UK case law has moved away from the widely defined Antipodean trigger moment for its operation. The reasoning in *Sequana* is extremely clear and persuasive. It may be that other Commonwealth jurisdictions will consider following its reasoning in preference to their own courts' decisions. Only time will tell, but what *Sequana* does is to bring some clarity to a question which has until now been opaque.

Although not mentioned in the judgment, the test adopted by the Court of Appeal in *Sequana* echoes and is consistent with the wording of the wrongful trading provisions found in the Insolvency Act 1986.[14] There is much to be said in favour of the consistency of terminology brought in by *Sequana*. Where a company's directors know or ought to know a company is insolvent or is likely to become insolvent, those directors are under a duty under section 172(3) of the Act, and the wrongful trading provisions of the Insolvency Act 1986, to act in the best interests of the company's creditors. This will normally involve them acting in a way to minimise potential loss to those creditors (adopting the wording of the defence found in the wrongful trading provisions). *Sequana* very helpfully brings together the statutory provisions dealing with the situation where directors must stop acting in the interests of a company's members and instead begin to act in the best interests of creditors. Consistency and clarity have helpfully been introduced.[15]

It should be remembered that the codified duties of a director are owed to the company. Following *Sequana*, it is now clear that once a company's directors know or ought

[14] Sections 214 and 246ZB Insolvency Act 1986.

[15] Sequana does for section 172, something very similar to what the courts did for the duty now codified in section 174 of the Act, the duty to exercise reasonable care, skill and diligence, where the duty in equity was found to be aligned to the duty owed under the wrongful trading provisions under the Insolvency Act 1986 (see e.g. *Norman v Theodore Goddard* [1992] BCC 14, [1992] BCLC 1028 and *Re D'Jan of London Ltd* [1993] BCC 646, [1994] BCLC 561).

to know that the company is insolvent or is likely to become insolvent[16] the directors thereafter are under a duty to the company to have regard to the interests of creditors. A breach of that duty will entitle the company to recover compensation for the loss caused to the company (which will include the loss indirectly caused to present and future creditors). The duty of the directors to have regard to the interests of creditors, in such circumstances, is not a duty directly enforceable by creditors against directors.

One point not fully addressed in the judgment of the Court of Appeal, as it did not arise as an issue, is the extent to which directors must take into account the creditors' interests once the duty is triggered. The two options are whether: 1) the interests of creditors are to be considered as paramount; or 2) their interests are to be considered, along with other factors such as those listed in section 172(1), without being decisive. Although making only an *obiter* statement, David Richards LJ states fairly categorically that "where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors' interests could be anything but paramount."

[16] The meaning of insolvency in this context includes both cash flow and balance sheet insolvency. Both types of insolvency are defined in section 123 of the Insolvency Act 1986. For an account of the current law on the meaning of insolvency see the Supreme Court decision in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* [2013] UKSC 28; [2013] 1 WLR 1408; which considers in some detail the legislative history of the definition of insolvency for which their Lordships derived great assistance from P Walton "Inability to Pay Debts: Beyond the Point of No Return?" [2013] *Journal of Business Law* 212.