HERBERT SMITH FREEHILLS

THE DUTY TO CONSIDER CREDITORS

01 March 2019 | London
Legal Briefings

In high stakes restructurings, directors can be under significant pressure from different parts of the capital structure to take (or refrain from taking) certain actions. It is critical that the board understands whether it owes duties to members or creditors (or both). For such an important issue, the law has previously been remarkably unclear. In a recent judgment[1], the Court of Appeal has clarified that the duty to have regard to the interests of creditors arises when the directors know or should know that the company i s or is likely t o become insolvent – with likely in this context meaning probable.

THE BACKGROUND

The facts are complex involving a liability relating to the extensive pollution of the Lower Fox River in Wisconsin. The essential findings of fact made by Mrs Justice Rose at first instance were that:

- the company liable for the clean up costs had three assets:
  - an investment contract for c. $250 million;

    - insurance policies for c. $100 million; and
    - a €535 million intercompany claim against its parent Sequana
- the directors considered the quantum of the clean up costs liability and properly concluded that the company had sufficient distributable reserves to declare a dividend
- the directors declared a €443 million dividend in December 2008, set off against the intercompany loan
- a few months later, Sequana became aware that some of the company's former management were willing to acquire the company and to take a commercial risk on the ultimate quantum of claims. To prepare for the sale, a second dividend of €135 million was declared in March 2009 reducing the intercompanyclaim to €3.1 million

The Lower Fox River clean up costs turned out to be significantly higher than anticipated. Proceedings challenging both dividends were issued against Sequana by BAT Industries plc as a potential creditor of the company and BTI (the latter being a vehicle set up by BAT that had acquired the company's claims against its directors).

THE ARGUMENTS AND FIRST INSTANCE DECISION

BTIchallenged the dividends on the grounds that:

- the directors either could not pay t he dividends (as they were not paid in accordance with Part 23 of the Companies Act 2006) or should not have paid the dividends (as they were paid in breach of the duties of a director under section 172 of the Companies Act 2006)
- each dividend was a "transaction defrauding creditors" under section 423 of the Insolvency Act 1986

After a 32 week hearing at first instance, Mrs Justice Rose held that:

- all claims in respect of the December dividend be dismissed
- the claims that the directors could not and should not have made the March dividend were dismissed
- the March dividend was nonetheless a transaction defrauding creditors

THE DECISION

In an extensive judgment by Lord Justice David Richards, the Court of Appeal dismissed both appeals and in doing so clarified the duty directors owe to the company to have regard to creditors' interests.

David Richards LJ noted that the case law underpinning this area is (relatively) new and was last considered by the Court of Appeal in West Mercia Safetywear Ltd v Dodd [1988] BCLC 250. Following a thorough review of the cases he noted that there is no decision in any English authority which is clearly based on the proposition that a duty to consider creditors' interests arises short of actual insolvency, although there are a number of times that judges of considerable experience have assumed that this is the case.

Ultimately, he considered that there are in principle four different points at which the duty to have regard to creditors' interests could be engaged:

- **actual insolvency:** David Richards LJ concluded that this is too narrow an approach as the duty may be triggered short of actual, established insolvency

- **imminent insolvency ("on the verge of insolvency" or "near-insolvent"):** he concluded this was not the correct test as it is temporal and requires that insolvency must be soon, not just likely, and there may be cases where although insolvency would not occur for some time, it was nevertheless likely and decisions taken now would prejudice creditors when that likely insolvency occurred

- **insolvency more likely than not ("likely to become insolvent" or "of doubtful solvency"):** he concluded (agreeing with Sequana) that this is the correct test and the duty is engaged when the directors know or should know that the company is or is likely to become insolvent, with "likely" in this context meaning probable

- **a realistic prospect of insolvency ("as opposed to a remote risk of insolvency"):** David Richards LJ rejected BTI's submission that this is the correct test and found that this goes beyond the current state of the law

Since it could not be said that the company was actually insolvent or likely to become insolvent at the time of the March dividend, the Court of Appeal upheld the High Court's decision that paying the dividend was not a breach of the duty to have regard to creditors' interests.

David Richards LJ expressly left open the question as to whether, once the duty is engaged, creditors' interests are paramount or are merely one factor to be considered without being decisive. Whilst he was prepared to comment (obiter) that creditors' interests would likely be paramount where the directors know or ought to know that the company is presently and actually insolvent, this is an important point left undecided. This is likely to be highly relevant when boards are responding to creditors who assert that their interests are the only, or the primary, interests the board should properly be considering.

TRANSACTIONS DEFRAUDING CREDITORS

The Court of Appeal upheld the first instance analysis of section 423 of the Insolvency Act 1986.

A transaction can be set aside under section 423 of the Insolvency Act 1986 if it is both a transaction:

- "at an undervalue", and
- entered into for the purpose of putting assets beyond the reach of creditors or potential creditors, or is otherwise intended to prejudice their interests.

David Richards LJ confirmed that in bringing such a claim there is no requirement that the company in question be insolvent, and no time limit (other than the general limitation periods) on when a claim can be brought (in contrast with a transaction at an undervalue or preference claim under sections 238 and 239 of the Insolvency Act 1986 respectively). Nor – despite the name – is it necessary that the directors acted fraudulently and it was possible for a distribution declared and paid in accordance with the Companies Act 2006 could be vulnerable to challenge. The key is that:

- it is the subjective intention of the company that is relevant
- it is not necessary that the purpose of putting assets beyond the reach of creditors is the sole or dominant purpose or for that to be something positively intended
- it is sufficient if this can properly be described as a purpose and not merely a consequence

The Court of Appeal therefore upheld Mrs Justice Rose's first instance decision that the March dividend was declared for the purpose of putting assets beyond the reach of BTI in the (unlikely) event that the Lower Fox River claims exceeded the company's other assets.

COMMENT

For such an important point in restructuring discussions, the Court of Appeal's decision has provided some much needed clarity. In practice, the usual debate between a board and the various jostling stakeholders in its capital structure during restructuring discussions is likely to continue as ultimately the various stakeholders will present their view as to whether as a matter of fact insolvency is likely and the creditors' interests duty is engaged. I t will remain the board's unenviable task to form a careful view as to whose interests they must consider, with what weight, to minimise the risk of personal liability in their preferred course of action.

It is not yet known whether permission to appeal to the Supreme Court will be sought or granted.

---

[1] *BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112*

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

JOHN WHITEOAK
PARTNER, LONDON

+44 20 7466 2010
john.whiteoak@hsf.com

KEVIN PULLEN
PARTNER, LONDON

+44 20 7466 2976
Kevin.Pullen@hsf.com

NATASHA JOHNSON
PARTNER, LONDON

+44 20 7466 2981
Natasha.Johnson@hsf.com

JOHN CHETWOOD
PARTNER, LONDON

+44 20 7466 7548
John.Chetwood@hsf.com

LEGAL NOTICE

SUBSCRIBE TO STAY UP-TO-DATE WITH LATEST THINKING, BLOGS, EVENTS, AND MORE

Close