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Client Alert
Commentary

Latham & Watkins Restructuring & Special Situations Practice | 11 October 2022 | Number 3020

Directors' Duties: Shining Light in the Tunnel?

In a new ruling, the UK Supreme Court concluded that the rule applies only when a company is "insolvent or bordering on insolvency".

On 5 October 2022, the UK Supreme Court handed down judgment in *BTI 2014 LLC v. Sequana SA and others (Sequana)*[1]. The case required the court to reconcile differing judicial pronouncements of the "creditors' interest rule" (the Rule) and consider the following questions:

- At what point in a company's financial descent must its directors prioritise the interests of the company's creditors over those of its shareholders?
- What action must directors take in order to discharge this duty?
- How should directors interpret the interests of the creditors?

This Client Alert summarises the judgment and explains the implications for company directors.

The Creditors' Interest Rule

The "creditors' interest rule" is a common law principle that requires directors to give consideration to, and in some circumstances prioritise, the interests of creditors over those of shareholders in the fulfilment of their fiduciary duties owed to the company. The Rule was first given judicial expression in the 1980s and has been developed in a number of cases since. The Rule was preserved by and enshrined in the Companies Act 2006, when the general duties owed by a director to a company were codified. The duty to promote the success of the company for the benefit of its members as a whole was made expressly subject to "any enactment or rule or law requiring directors, in certain circumstances, to consider or act in the interests of the creditors of the company" (section 172(3)).

In *Sequana,* a company paid two large dividends to its parent at a time when the company had ceased trading but remained subject to contingent liabilities in respect of indemnities for clean-up costs and damages arising from environmental liabilities. At the time of the payment of the dividend, the company was solvent on both a balance sheet and cash flow basis. However, there was uncertainty around the amount of the long-term environmental contingent liabilities, which gave rise to a real risk that the company might become insolvent at an unknown future time. In the event, it entered into administration 10 years after payment of the dividend.

When Is the Rule Engaged?

The Court of Appeal had rejected the argument that the Rule was engaged where there was merely a "real as opposed to a remote risk of insolvency" as something that would have a "chilling effect on entrepreneurial activity". The court instead found that the Rule arose "when the directors know or should know that the company is or is likely to become insolvent".

The Supreme Court unanimously agreed with the Court of Appeal's finding that the solvency of the company at the time that the dividend was paid meant that the Rule had not been engaged. However, the Supreme Court unanimously rejected the Court of Appeal's formulation of the Rule, choosing to dispose of any probability element in favour of concluding that the Rule applies only when a company is "insolvent or bordering on insolvency". This formulation narrows the Rule's window significantly and pushes it closer to the test under which wrongful trading liability is engaged ("no reasonable prospect of avoiding insolvent liquidation" under section 214 of the Insolvency Act 1986). Indeed, Lord Briggs expressly couched the Rule in terms of seeing "light at the end of the tunnel", which is familiar shorthand in advice to directors on wrongful trading.

Sliding Scale of Creditor Interests: No Cliff-Edge

The Supreme Court rejected the concept that, at the time the Rule is engaged, the interests of creditors become "paramount". The court found this line of case law inflexible because it failed to account for the necessary balancing of shareholder and creditor interests before insolvency became inevitable. Up until that point, the directors' fiduciary duty to act in the company's interests has to reflect the fact that both the shareholders and the creditors have an interest in the company's affairs. Where those interests are in conflict, a balancing exercise will be necessary to reflect their respective weight in the light of the gravity of the company's financial difficulties.

This should be seen as a sliding scale rather than a cliff-edge: the more parlous the financial state of the company, the more the interests of the creditors will predominate, and the greater is the weight that should be given to their interests as against those of the shareholders.

Directors may take practical comfort in the knowledge that they need not consider exclusively the interests of creditors unless and until insolvent liquidation or administration becomes inevitable. Each assessment will therefore be necessarily and heavily fact-specific.

The Nature of the Duty

The Supreme Court was reticent to address what "having consideration for the interests of creditors" (when the Rule has been triggered) and "acting in their interests" (at the point where liquidation is inevitable and the creditors become the main economic stakeholders in the company) actually entail. Instead, the court preferred to frame the duty in terms of what directors should not do: specifically, they should not exercise any of their powers so as to harm creditors' interests (Lady Arden). Lord Reed referred to the "interests of the company's general body of creditors" despite acknowledging that some creditors may be more equal than others in any given situation.

Nevertheless, where the Rule is engaged, directors "must include consideration of the interests of its creditors as a class rather than as a fixed group of individuals". This fails to address the practical quandary faced by many directors of companies in distress of using new debt to pay old debt (or 'robbing Peter to pay Paul', as it is sometimes framed). Would those commonplace decisions fall foul of the refocused fiduciary duty to consider creditors' interests as a whole?

The panel also expressed different opinions on whether it is necessary that a director knows or ought to know that the company is insolvent or bordering on insolvency in order for the Rule to apply. The majority held that a director needs to know, but this remains open to further argument in future cases.

Qualified Clarity for Directors

The judgment provides a qualified clarity for directors (and those advising them) on the following points:

- The “creditors’ interest rule” is affirmed as a duty to consider creditors’ interests when a company is insolvent or bordering on insolvency.
- The duty is derivative of and a modification to the director’s fiduciary duty to the company to promote the success of the company — not an independent duty owed to its creditors.
- The extent of the modification of the duty away from the interests of shareholders and towards those of creditors will be dictated by the degree of the company’s financial difficulties.
- Where the directors are under a duty to act in good faith in the interests of creditors, the shareholders cannot authorise or ratify a transaction which is in breach of that duty.
- Payment of otherwise lawful dividends may be in breach of the Rule, depending on the financial state of the company at the time of the payment.
- The duty to consider shareholder interests is displaced completely by creditor interests only at the point at which liquidation is inevitable; up until that time, directors may legitimately form commercial judgements of any transactions that are in the interests of both the company’s shareholders and its creditors.

The Rule will continue to evolve as cases that on their facts engage it more precisely than *Sequana* appear before the courts. Latham & Watkins will continue to provide guidance on what these cases mean for the application of the Rule.

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Endnote

[1] *BTI 2014 LLC v Sequana SA and others* [2022] UKSC 25.