ON**POINT** / A legal update from Dechert's Financial Restructuring group

Sequana: "Momentous" Judgment by Supreme Court on the Creditor Duty

Authored by Kay Morley and Tayyibah Arif

October 2022

Dechert LLP

Sequana: "Momentous" Judgment by Supreme Court on the Creditor Duty

October 2022 / Authored by Kay Morley and Tayyibah Arif

Overview

The Supreme Court has ruled, for the first time, on the existence, specific content and engagement of the so-called "creditor duty" or the "rule in West Mercia". In doing so, it unanimously dismissed BTI's appeal.

Directors should continue to seek early and timely legal and financial advice and constantly monitor the financial position of the company as it enters the twilight zone or faces financial difficulties.

The judgment is available here. Here is a summary of the key takeaways:

Is there a common law creditor duty at all?

YES

- Section 172(1) of the Companies Act 2006 ("**CA 2006**") requires a company director to *"act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole"*. The Supreme Court held that, in certain circumstances, this duty is modified by the common law rule that a company's interests are taken to include the interests of the company's creditors as a whole. The **creditor duty is affirmed** because:
  - It is **firmly established in English common law** (even though of comparatively recent origin) and supported by a long line of case law in the English courts as well as in Australia and New Zealand.
  - **Section 172(3) of CA 2006** makes the statutory duty in s.172 subject to *"any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company"*. Accordingly, this section **has the effect of affirming or preserving the creditor duty**.
  - The creditor duty has a **coherent and principled justification** as the creditors always have an economic interest in the company's assets, but the relative importance of such interest increases as the company nears insolvency or is insolvent. In such circumstances, the directors must manage the company's affairs in a way that takes creditors' interests into account, balanced against the interests of the other stakeholders, and seek to avoid prejudicing them.
- The creditor duty is **not a separate or free-standing duty** that is owed to the creditors but rather, an aspect of the director's duty to the company. The directors owe their duties to the company, rather than directly to shareholders or creditors.

What is the so-called "creditor duty"?

This is the duty, introduced into English common law by the leading case of *West Mercia Safetywear v Dodd*[1] in 1988, of company directors to consider, or act in accordance with, the interests of the company's creditors when the company becomes insolvent, or when it approaches, or is at real risk of insolvency.

Background

In May 2009, the directors of the company, AWA, paid a dividend to its sole shareholder of nearly all its net assets of €135 million. This was a lawful distribution in accordance with Part 23 of CA 2006 and, at the time, AWA was solvent, on both a cash flow and balance sheet basis.

However, it had a major contingent environmental liability of an uncertain amount which (together with uncertainty as to value of one class of asset) gave rise to a real risk, although not a probability, that AWA might become insolvent at an uncertain but not imminent future date.

An insurance policy was obtained to cover this contingent liability which turned out to be insufficient to cover the liability in full.

AWA subsequently entered insolvent administration in October 2018. BTI 2014 LLC ("**BTI**"), as assignee of AWA's claims, brought a claim against AWA's directors for an amount equivalent to the dividend payment on the basis that their decision to distribute the dividend was in breach of the creditor duty.

Court of Appeal Decision

The Court of Appeal (judgment available here) held that the creditor duty did not arise until a company was either actually insolvent, on the brink of insolvency or probably headed for insolvency. A risk of insolvency in the future, however real, was insufficient unless it amounted to a probability. Although the dividend was lawful, this did not of itself prevent its payment amounting to a breach of the creditor duty, had it arisen by May 2009. Accordingly, it dismissed BTI's appeal.

- Directors are **not required to consider the interests of particular creditors in a special position** but rather, to consider interests of creditors as a general body.
- **Shareholder authorisation or the ratification principle does not prevent the recognition of creditor duty or insulate directors from liability to the company**, nor can shareholders ratify a transaction that is in breach of this duty in circumstances where the directors are under a duty to act in the creditors' interests. There can be no shareholder ratification of a transaction entered into when the company is insolvent, or which would render the company insolvent.
- There is similarly **no conflict between creditor duty and section 214 of the Insolvency Act 1986** ("**IA 1986**") dealing with wrongful trading. Section 214 of IA 1986 is engaged where insolvency is inevitable and creates an obligation on directors to treat creditors' interest as paramount when there is no light at the end of the tunnel.[2]

Can the creditor duty apply to a decision by directors to pay an otherwise lawful dividend?

YES

- Part 23 of CA 2006 is subject to any rule of law to the contrary (s.851(1) CA 2006). This includes the creditor duty which is a part of common law and has been recognised by s.172(3) of CA 2006.
- Part 23 identifies profits available for distribution on a balance sheet basis so the directors of a company which is cash flow insolvent cannot lawfully distribute a dividend pursuant to Part 23. Therefore, **a decision to pay a dividend that is lawful under Part 23 may still be taken in breach of the creditor duty**.

What is the content of the creditor duty?

- Where a company is **insolvent, or bordering on insolvency, but insolvent liquidation or administration is not inevitable**, the directors should **consider the creditors' interests**, to give them **appropriate weight**, and to **balance them against the shareholders' interests where they may conflict**. The greater the company's financial difficulties, the more the directors should prioritise the creditors' interests.
- Certain circumstances may require shareholders' interests to be treated as subordinate to those of creditors – this is a fact-sensitive question depending "*upon the brightness or otherwise of the light at the end of the tunnel*" (i.e. the degree of likelihood that a company's course of action may reasonably lead it away from threatened insolvency).
- Where **insolvency is inevitable**, there being no light at the end of the tunnel, the **creditors' interests become paramount** as the shareholders cease to retain any valuable interest in the company.
- The rule of West Mercia is not limited to consideration of creditors' interests but also requires the directors not to harm those interests. **Progress towards insolvency may not be linear** and the directors should stay informed of the company's financial position.[3]

When is the creditor duty engaged?

- Creditor duty is engaged 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**. An open

---

1 West Mercia Safetywear Ltd (in liq) v Dodd [1988] BCLC 250.

2 As per Lord Briggs' judgment.

3 As per Lady Arden's judgment.

question by the minority[4] remains as to whether it is essential that the directors know or ought to know that this is the case. Therefore, either "*imminent insolvency (i.e. an insolvency which directors know or ought to know is just round the corner and going to happen) or the probability of an insolvent liquidation (or administration) about which the directors know or ought to know, are sufficient triggers for the engagement of the creditor duty*."

- The "*bare probability of insolvency, which may only be temporary, does not of itself make a liquidation probable*". It is too early and the **creditor duty does not apply merely because a company is at a real (and not remote) risk of insolvency**. This is a common feature among companies.
- In slight disagreement with the Court of Appeal, it is **not enough in that insolvency itself, from which company may well recover, is probable**.

This update was authored by:

Kay Morley
Partner
London
+44 20 7184 7556
kay.morley@dechert.com

Tayyibah Arif
Counsel
London
+44 20 7184 7377
tayyibah.arif@dechert.com

Alastair Goldrein
Partner
London
+44 20 7184 7456
alastair.goldrein@dechert.com

Solomon Noh
Partner
London
+44 20 7184 7337
solomon.noh@dechert.com

Adam Plainer
Partner
London
+44 20 7184 7555
dam.plainer@dechert.com

---

[4] Lord Reed and Lady Arden.