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UK Court of Appeal: When to Trigger the Creditor Duty Shift

Ruling provides guidance on how close to insolvency a company needs to be before directors must consider creditors' interests.

The UK Court of Appeal has ruled that the payment of a lawful dividend did not, on the facts, amount to a breach of the directors' duty to have regard to creditors' interests. The facts indicated that the company was not insolvent, or close enough to insolvency, for the "duty shift" from shareholders to creditors to be triggered. In so doing, the court concluded the duty is activated not just on insolvency but also when directors ought to know the company is or *is likely* to become insolvent, which carries with it a "probability" threshold.

Case Facts

The facts below repeat those set out in the Client Alert *UK Court of Appeal: Creditors Can Seek to Reverse Lawful Dividend Payments*. *Click here to skip to the analysis.*

Arjo Wiggins Appleton Limited (AWA) paid two large dividends to its parent company, Sequana SA (Sequana), at a time when AWA had ceased trading and was subject to contingent liabilities in respect of indemnities for cleanup costs and damages arising out of river pollution in the United States. The dividends were paid by way of set-off against part of an inter-company debt Sequana owed AWA. The claimant (a potential creditor of AWA) challenged both dividends on the basis that:

- The dividends were paid in breach of the AWA directors' duty to have regard to the interests of AWA's creditors (which the court termed the "should not pay" claim).
- The payment of the dividends amounted to a transaction at undervalue within Section 423 of the Insolvency Act 1986 (s. 423), and so was liable to be reversed on application by creditors.

The claimant brought the "should not pay" claim on the basis that the directors were aware that the estimate of the environmental liability was surrounded by uncertainty and possibly way off the mark. At first instance, Justice Rose dismissed the "should not pay" claims but accepted the s. 423 claim. The claimant appealed against the dismissal of the "should not pay" claim, and AWA appealed against the High Court's decision that the dividend payments fell within the meaning of s. 423. This *Client Alert* considers the appeal brought by the claimant, an assignee of the rights AWA had against the directors of Sequana (Appellant assignee), on the "should not pay" claim. In *UK Court of Appeal: Creditors Can Seek* *to Reverse Lawful Dividend Payments*, the authors discuss the other aspect of the judgment, being the application of s. 423.

The Duty Shift

Before delving into the judgment, this *Client Alert* will provide a brief reminder of the so-called "duty shift". The Companies Act 2006 codifies the general duties owed by a director to a company, which are based on common-law rules and equitable principles. In particular, Section 172 of the Companies Act 2006 (s. 172) provides:

> *(1) A director of a company must 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 ... (3) The duty imposed by this section has effect 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.*

In other words, the general duty under s. 172(1) to promote the success of the company for the benefit of shareholders has effect subject to the fiduciary, common-law duty of directors to consider creditors' interests "in certain circumstances", as preserved under s. 172(3).

A few elements of these duties are important to note:

- The leading English 1988 case on the duty shift established that the directors of an insolvent company ought to have regard to creditors' interests, the rationale being that the assets are in a practical sense the assets of the creditors, pending liquidation or a return to solvency.

- Subsequent cases have shown that something less than insolvency can trigger the duty shift, but what that precisely amounts to has been subject to many formulations by the courts and is not clear.

- A decision taken by a director in breach of the duty to take into account creditors' interests cannot be approved or ratified by the shareholders of an insolvent company to make it lawful.

- The duty under s. 172 is owed only to the company and not its creditors, so even if the circumstances call for a duty shift, creditors have no direct recourse against the company for breach of duty.

- Even if the duty shift has occurred, a failure of directors to have regard to creditors' interests is not automatically a breach of duty, if it can be shown that the directors could have reasonably concluded the transaction would have been approved even if the creditors' interests were taken into account.

- Although the law remains unclear, the prevailing consensus seems to be that if the duty shift has decisively occurred, creditors' interests trump those of shareholders.

The Key Question

The key question for the court was therefore how close to insolvency a company needs to be to trigger the duty shift. The claimant, as assignee of AWA's rights against the directors, argued that directors owe a duty to consider creditors' interests if a proposal involves a *real*, as opposed to a *remote*, risk to creditors (as is the case under, for example, Australian and New Zealand law). Another argument put forward was that the shift is triggered when creditors have a "sufficiently strong stake in the conduct of the company's business and activities" (para 196).

The Court of Appeal’s Conclusion

The court rejected the Appellant assignee’s arguments. In particular, the court concluded that references to a “real risk” or to a “stake” in the business would create a new test, one that “predictably would have a chilling effect on entrepreneurial activity” (para 200).

The court recognised that previous decisions had allowed something less than actual insolvency, including, for example, something “of doubtful insolvency or on the verge of insolvency” (para 169). However, there has been a reluctance to “formulate a general test of the degree of financial instability” (para 155), primarily due to the difficult interplay of policy, principle, and pragmatism, partly reflected in the inherently conflicting interests of shareholders and creditors.

The court identified various formulations on a sliding scale, with others “too vague to serve as a useful test”[1] and deciding the last test as resolutely *not* part of present law:

> *Actually insolvent* → *On the verge of* → *Is likely to become* → *Real as opposed to remote risk*

The court agreed that any argument that the duty should arise only in cases of actual insolvency should be rejected, because it is often difficult to pinpoint the precise moment of insolvency. The court did not favour the second test, as that would require actual insolvency to arise within a short time, which would fail to cover those situations in which “(…) the company may be able to pay its debt as they fall due for some time (…) to come (the cash-flow test), but *not* those in which (with a presumed reference to the balance-sheet insolvency test) “insolvency is nonetheless likely to occur and decisions taken now may prejudice creditors when the likely insolvency occurs”.[2]

According to the court, the following formulation more accurately described the trigger:

> *The duty to have regard to creditors’ interests arises “when the directors know or should know that the company is or is likely to become insolvent”.*[3]

Finally, the court acknowledged that the duty shift leads to a difficult reconciliation of the interests of shareholders and creditors. However, in an obiter comment, Lord Justice Richards did indicate that once the court’s preferred test was met, creditors’ interests were clearly “paramount”, meaning they trumped those of the shareholders.

Implications

The court’s formulation should give directors and creditors alike more certainty as to the trigger of the duty shift. To review:

- The court said “likely” means “probable”. As confirmed in other cases, these expressions can be interpreted to mean something is expected to happen.

- The court appears to have linked the trigger to that applicable to filing for administration, where the court makes an order only if it is satisfied “that the company is or is likely to become unable to pay its debts” (along with the requirement related to the purpose of the administration). Presumably, the court preferred a test aligned to a statutory one, supported by existing case law, and with which judges will be more familiar.

- Although the duty of a director under s. 172 is seen as a fundamentally subjective one, when considering a breach, courts will look at the surrounding circumstances to decide whether the director's conduct was on its face reasonable.
- In its discussion of the formulations of the duty shift test, the court makes clear that "insolvency" could be cash flow or balance sheet or a combination of both as per Section 123(1) and (2) IA.

Conclusion

The Court of Appeal has provided clarity on the question of at what point directors must take creditors' interests into account when fulfilling their duty to promote the success of the company. However, the duty shift remains a test subject to the court's discretion and the facts of the case. The judgment will serve as a stark reminder to directors to take decisions extremely carefully once there is a heightened risk of insolvency, bearing in mind a court will assess what facts the directors were taking or should have taken into account, and in what manner. As explained in *UK Court of Appeal: Creditors Can Seek to Reverse Lawful Dividend Payments*, these facts include entering into material transactions such as the payment of dividends (even if they can be considered lawful under the Companies Act 2006), particularly if the company has ceased trading and if actual and potential liabilities could exceed the company's assets.

As mentioned, the Appellant was an assignee of the claim against the Sequana directors. Both the first instance and Court of Appeal judgments are silent on the circumstances of the assignment. This silence may have been possible (not giving rise to issues of maintenance and champerty) on the basis that the Appellant assignee had a legitimate interest in the litigation as it (through its parent) had its own claim under s. 423 against the directors as a potential creditor of AWA. The market for the assignment of claims, both in and outside of insolvency, and as part of that, the funding of litigation, has become increasingly active, and Latham foresees this trend continuing.

Lastly, an application for permission to appeal to the Supreme Court is pending, meaning this important issue may yet face further scrutiny.

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Endnotes

1 Para 213 of the Judgment.

2 Para 291 of the Judgment.

3 Para 220 of the Judgment.