DIRECTORS' DUTIES AND CREDITORS

PROFESSOR CHRIS RILEY, MODULE CONVENOR FOR COMPANY LAW

Transcript

Hello. This blog is looking at an important recent decision of the Supreme Court, which addresses how the duties of directors might change when a company is in financial difficulties.

The duty that is found in section 172 of the Company Act 2006, to promote the success of the company, generally requires directors to put shareholders first. Directors must still think about the interests of other stakeholders, such as employees or consumers, but only in order to work out, in a more sophisticated (or 'enlightened') way, what actions will ultimately benefit shareholders most.

However, the courts have long acknowledged that this duty does change once a company is in financial difficulties. In such situations, directors must give greater weight to creditors' interests. That point was accepted in West Mercia Safetywear back in 1988, but it has now been given further consideration by the Supreme Court, in BTI [2014] v Sequana.

The case concerned a UK company, AWA Ltd, which was wholly owned by Sequana SA. By 2009, AWA Ltd knew that it faced potential liability for environmental clean-up costs in the US. It was unsure, however, how much this liability might eventually cost it. There was a risk it could make AWA insolvent, but in 2009 insolvency was not yet a probability. AWA therefore went ahead and paid out a very large dividend to Sequana, amounting to 135 million Euros. The clean-up costs turned out to be very large indeed, and 10 years later they eventually lead to AWA's insolvent liquidation.

In the winding up of AWA, proceedings were brought against AWA's directors, claiming that they had breached their duty under section 172, by paying out that large dividend to the shareholder when AWA already faced some risk of insolvency. Earlier courts in the case had rejected that claim, holding that AWA's financial situation by 2009 was not yet so serious as to trigger any change in section 172; directors were still entitled to put the shareholder first and to pay the dividend.

The Supreme Court agreed with that outcome. It confirmed that the duty in s172 does move away from its traditional approach of putting shareholders first, once the company is in financial difficulties, but it found that the company's difficulties in this case were not sufficiently serious to trigger that move by 2009.

As to when the duty does change, the Court held that this certainly happens once an insolvent liquidation is inevitable, but it will also occur, even before then. It is not sufficient, however, that there is merely some risk of such a liquidation. Rather, an insolvent liquidation must be 'probable'. Applied to the AWA case itself, there was certainly a risk of insolvency in 2009 when the directors decided to pay the dividend to their shareholder, but insolvent liquidation was by no means probable at that time.

The Court's decision regarding this 'trigger point' for the change to section 172 effectively disposed of this case. However, the Court chose to address several other issues around the duty, although strictly speaking the views expressed were then obiter.

First, regarding how much weight directors must give to creditors' interests, the Court envisaged a sliding scale approach. Once insolvency becomes probable, so that the change in the duty is triggered, directors must then start to balance the interests of shareholders and creditors. The weight to be given to creditors will then increase as the company's financial problems become worse and the 'point of no return' comes closer. And once insolvent liquidation has become not merely probable but now inevitable, then the balancing ends, and directors must then prioritise creditors.

Second, although the content of section 172 may change, the duty itself remains, like all other duties, owed to the company, and therefore is ordinarily enforceable only by the company. It can't be enforced by, say, an individual creditor who feels they in particular have suffered because of the directors' failure to consider their interests.

Third, the court also found that if the directors do breach section 172 by failing to give enough weight to creditors' interests, then such a breach cannot be authorised or ratified by shareholders. That seems to make sense. The change in the section 172 duty is intended to benefit creditors, and not shareholders. It would render that change largely pointless if shareholders could still excuse any such breach.

There was one issue, however, where the members of the Court failed to agree, namely whether directors must themselves be aware of the probability of insolvent liquidation, or whether it's sufficient that they ought to have been aware.

The duty in section 172 is framed in terms of the director's 'good faith'. In other cases on section 172, that reference to good faith has been interpreted as making the duty a subjective one. Courts should focus on what the directors themselves were thinking or knew, not what a reasonable director might have thought or known. But if this subjective interpretation of the duty does mean that directors must themselves be aware of the probability of insolvency before the duty changes, then it will make it much more difficult for liquidators to enforce it against directors.

It is worth asking, finally, how significant this duty to think about creditors is, especially given the existence of the wrongful trading provision in s214 of the Insolvency Act 1986. That provision, remember, effectively requires directors to think about – and indeed to prioritise – creditors' interests.

However, one significant limit on section 214, is that it does only apply once an insolvent liquidation is inevitable. The duty to give weight to the interests of creditors under s172 can, as we have seen, arise before that time, when an insolvent liquidation is still not inevitable but has now become at least probable. Although that did not help the claimants in the BTI case, this difference in the 'trigger points' for these two different provisions could sometimes be significant.

And from a more practical point of view, the fact that the section 172 duty can arise earlier should prompt directors to take more advice, once their company is in financial difficulties, about how likely liquidation has become, and whether the actions that they are contemplating do strike a fair balance between the interests of the creditors and of the shareholders.

Thank you.