UK Supreme Court Confirms Creditor Duty in Zone of Insolvency: *BTI v Sequana*

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KEY POINTS

- The UK Supreme Court has affirmed directors' duty to consider creditors' interests.
- The timing for the duty to be engaged is pushed back to when a company is bordering on insolvency.
- Once the duty is triggered, a balancing exercise must take place between creditor and shareholder interests, the relative weight of each being on a 'sliding scale' – the closer to insolvency, the more weight that should be given to creditors' interests (which become paramount once insolvent liquidation or administration is inevitable).

Background

The long-awaited judgment of the UK Supreme Court in *BTI 2014 LLC v Sequana SA* [2022] UKSC 25 was finally handed down on 5 October 2022.

The question on appeal concerned (i) whether directors must have regard to the interests of creditors (the '**creditor interest duty**'); and (ii) if so, when the creditor interest duty arises. In deciding these issues, the Court also gave a provisional view on a number of related points. The extent to which these additional views provide answers for directors or simply pose further questions remains to be seen.

Separate judgments were delivered by Lord Reed, Lord Briggs (with whom Lord Kitchin agreed), Lord Hodge and Lady Arden. The full judgment can be found here.

What Conclusions Did the Supreme Court Reach?

On certain key issues, the judges were able to reach a unanimous decision as follows:

1. **Creditor interest duty exists**: Perhaps unsurprisingly, the judges agreed that a duty to act in the interests of creditors exists, albeit that it is not a separate or standalone duty owed to creditors, but a modified form of the director's fiduciary duty to act in good faith for the best interests of the company. The judges considered that this modification to the duty to the company was well-established and justified on the basis that, as insolvency approaches, creditors assume an economic interest in the company and its assets.
2. **Trigger point:** Overturning the decision of the UK Court of Appeal, the judges held that the creditor interest duty arises *when a company is actually insolvent or bordering on insolvency or insolvent liquidation or administration is probable*. It does not apply merely because a company is at a real and not remote risk of insolvency at some point in the future. This is a later stage in the path to insolvency than had been

determined by the Court of Appeal. The reason for moving the trigger point was said to be because that is the point where the interest of creditors and shareholders may begin to diverge and, accordingly, where the interests of creditors should therefore be considered.

As to whether the test above requires that the directors know or ought to know of the insolvency of the company, the judges did not agree. The majority suggested that knowledge was necessary, whereas Lord Reed and Lady Arden indicated that this issue remained open, particularly as directors already have a duty to inform themselves of a company's financial affairs. Lady Arden suggested the burden of proving a lack of knowledge ought to be on the director.

3. **Scope - sliding scale:** The judges did not agree with the formulation in certain prior authorities that, once the creditor interest duty was triggered, then the duty to creditors became paramount to the exclusion of the interests of shareholders. It was instead decided that a balancing exercise must take place between the interests of creditors and shareholders – the closer to insolvency, the more weight that should be given to creditors because it was they who began to assume the greater risk and had the greater economic interest.

   Once insolvency is inevitable and there is "*no light at the end of the tunnel*", creditors' interests are to be treated as paramount and members' interests will cease to bear any weight. Lord Briggs expressed this by reference to the test for wrongful trading under Section 214 of the Insolvency Act (IA) 1986 and said that creditors' interests become paramount once insolvent liquidation or administration is inevitable.

What Issues Remain to Be Determined?

While the Supreme Court considered a number of interrelated issues, only the above decisive conclusions were reached, with other issues being discussed *obiter* and only provisional views of the judges expressed. This means certain issues remain live and a number of uncertainties remain. Of particular note:

1. The Court did not address directly how the creditor interest duty is applied where the interest of individual creditors may not be aligned or where the position of certain creditors has worsened in contrast to creditors as a whole.

2. Whilst the Court unanimously confirmed the line from which the creditor interest duty is engaged, it still remains challenging for directors and their advisers to be sure, in the context of company-specific facts, when that line is crossed. When does insolvent liquidation become 'probable'?

3. Given that the appeal was dismissed, the Court did not further consider the consequences of breach of duty or the forms of relief available.

4. The interplay between breach of duty claims and those under the statutory regime (such as wrongful trading and preferences under Section 239 of IA 1986) remain unclear.

Practical Implications

For directors and their advisers, the judgment provides welcome news by pushing back the date at which creditors' interests need to be taken into account from the date decided upon by the Court of Appeal. It has also been confirmed that a balancing exercise needs to be undertaken between creditor and member interests, with consideration of the particular circumstances of the company and its financial position at a given time. This is an important clarification.

Nevertheless, the judgment does not provide a panacea to the questions of when the duty to consider creditor interests is engaged and the scope of such duty. The friction between considering the interests of creditors as a whole and individual creditors remains and, practically, identifying the trigger point will continue to be a challenging exercise. When a company is insolvent or bordering insolvency is heavily fact-sensitive and will require the exercise of careful commercial judgment by directors and the taking of advice. Further evolution of the law is therefore expected.

What was clear from the judgment was that the Court recognised that companies will suffer periods of financial difficulty bordering on insolvency and that, at such times, this should not result in the duty to shareholders being extinguished. Whilst the balancing exercise between shareholders and creditors in such circumstances may not always be easy, this approach does potentially allow businesses to try and work through these difficult periods for longer than had previously been the case.

CONTACTS

For further information, please contact your Katten lawyer or any of the following:

Prav Reddy
+44 (0) 20 7770 5213
prav.reddy@katten.co.uk

Sonya Van de Graaff
+44 (0) 20 7770 5221
sonya.vandegraaff@katten.co.uk

Mark Johnson
+44 (0) 20 7770 5214
mark.johnson@katten.co.uk

Dominique Hodgson
+44 (0) 20 7770 5239
dominique.hodgson@katten.co.uk

Georgina Vale
+44 (0) 20 7770 5232
georgina.vale@katten.co.uk

Katten katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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