On 5th October 2022, the Supreme Court handed down their landmark judgment in the long-running case of BTI 2014 LLC v SequanaSA, which concerns the circumstances and extent to which the company directors must consider the interests of creditors with regard to their common law duties. Although decisions of the UK Supreme Court are not binding in Jersey, it will nevertheless be highly persuasive.

Summary of case

In May 2009, the directors of a company called AWA paid a dividend of €135 million to its only shareholder Sequana SA(the "Dividend"). At the time the Dividend was paid, AWA was solvent and the payment of the Dividend was compliant with the statutory requirements under the Companies Act 2006.

However, AWA had long-term contingent liabilities (which in this context means potential liabilities that may occur in the future) of an uncertain amount in respect of clean-up costs relating to the pollution of a river. This gave rise to a 'real' risk that AWA might become insolvent in the future, although insolvency was not 'probable'.

In October 2018, (some 10 years after the dividend) the liabilities materialised and AWA went into insolvent administration. BTI 2014 LLC ("BTI") was the assignee of a creditor of AWA which had suffered loss as a result of AWA's insolvency. BTI brought claims for breach of duty against the directors on the grounds that they failed to consider the interests of AWA's creditors when deciding to authorise the Dividend.

BTI lost at first instance and in Court of Appeal, as both courts took the view that the duty to have regard to creditors' interests did not arise at a time when the company was solvent and the future risk was not imminent or probable.

Supreme Court Decision

The Supreme Court justices were unanimous in their dismissal of BTI's appeal on the grounds that, although a duty to consider the interests of creditors does indeed exist, a "real risk" of insolvency is not sufficient.

The key points from the judgment were as follows:

1. Is there a common law creditor duty?

The Supreme Court affirmed the existence of the duty to consider the interests of creditors (otherwise referred to as the rule in West Mercia) and agreed that a director's duty to act in good faith in the company's interests is modified in certain circumstances such that the company's interests are taken to include the interests of its creditors as a whole.

When the creditor duty arises, it merely adjusts the long-established fiduciary duty to act in good faith in the interests of the company. In other words, when the rule applies, the way in which the company's interests are understood, for the purposes of that duty, is extended so as to encompass the interests of the general body of creditors as well as the interests of the general body of shareholders.

Directors, under certain circumstances, must therefore have regard to and consider the interests of a company's creditors and prospective creditors.

The duty was affirmed for a number of reasons, including that creditors have an obvious economic interest in the company and its assets, distinct from the interests of the company's shareholders, which increases in relative importance when the company is bordering on insolvency.

2. When is the creditor duty engaged?

The Supreme Court further clarified that the duty to consider creditors' interests is engaged where 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.

Importantly the Supreme Court confirmed that the "creditor duty" is not engaged when there is merely a "real" risk of insolvency.

Lord Reed(one of the Supreme Court judges)stated, by way of example, that, as long as the company is financially stable, its shareholders will normally have a predominant economic interest in the manner in which its affairs are managed, and their interests will normally be aligned with those of its creditors. However, when the company is in financial difficulties the economic interest of its creditors become distinct from those of its shareholders and are liable to become increasingly predominant as the company's situation deteriorates. That shift in interests does not occur merely because there is a real but not remote risk of insolvency. In that eventuality, the predominant interest will normally continue to be held by the shareholders, and the interests of creditors will not require separate consideration.

The creditor duty was, therefore, more likely deemed to have been engaged when the company is insolvent or bordering on insolvency which, as the Court noted, conveyed a "sense of imminence."

As to what was meant by insolvency, this was held to be based on the cash flow (or commercial) the insolvency or on balance sheet insolvency.

The Supreme Court declined to reach a definitive opinion on whether the directors should be judged on whether they knew (or ought to have known) that the trigger point had been reached, leaving this point for potential future submissions and consideration.

However, it was noted that directors are generally under a duty to inform themselves as to the company's affairs. In the absence of a judicial decision to the contrary, it remains essential that directors, therefore, keep a very watchful eye on the solvency of the company, with the benefit of up-to-date financial information and professional advice.

3. What is the scope of the creditor duty

The Court held that, as a general rule, the more parlous the state of the company, the more the interests of the creditors will predominate, and the greater the weight which should therefore be given to their interests as against those of the shareholders.

Indeed, this would most clearly be the position where an insolvent liquidation or administration is inevitable, and the shareholders consequently cease to retain any valuable interest in the company.

However, as Lady Arden (also one of the Supreme Court judges)noted, although a sliding scale approach provides some assistance, it should not be taken too literally. The progress towards insolvency may not be linear and may occur not as a result of incremental developments but as a result of something outside the company which has a sudden and major impact on it. The task for directors is not simply to weigh the interests of shareholders against those of creditors, it is to manage all the interests in the company unless and until the point is reached whereby they must treat creditors' interests as predominant.

Interestingly, it was also held that the interests of "creditors" are the interests of creditors as a general body; indeed, the directors are not required to consider separately the interests of particular creditors in a special position.

4. Shareholder Ratification of Director Duties

The judgment acknowledged that, where directors were involved in a breach of duty to the company affecting the interests of shareholders, then shareholders could either authorise that breach or ratify it in retrospect. However, the Court held that where the interests at risk were those of creditors, there was no reason in law or logic to recognise that the shareholders could authorise such a breach. Once it was accepted that the directors' duty to a company as a whole extended in an insolvency context to not prejudicing the interests of creditors, the shareholders did not have the power or authority to absolve the directors from such a breach.

These comments largely reflect the position already adopted under Jersey law. Indeed, shareholder ratification of a director's acts are only possible under the Companies (Jersey) Law 1991 in cases where the company will be (cash flow) solvent after the time when the act or omission to be ratified occurs.

Practical Considerations

In light of this judgment, it is crucial for directors to stay up-to-date with the company’s affairs and assess its financial position regularly, with the general principle being that the greater the financial difficulties of the company, the greater weight and consideration should be given to the creditors’ interest. Practical steps could include:

1. Regularly convening board meetings at which the affairs of the company can be reported on and discussed on a periodic basis;

2. Holding board meetings in relation to material transactions (for example, payment of dividends and mergers & acquisitions), which should be properly documented even before the creditor duty is engaged;

3. Close monitoring of the company’s financial position to ensure directors are well-positioned to respond to periods of turbulence and adapt to changing (and competing) stakeholder demands;

4. Boards should consider engaging professional advice sooner rather than later–professional legal and accountancy advice may help to avert a distress scenario from arising (or from worsening)but, failing that, evidence of reliance upon independent advice could assist in showing that the directors who have acted honestly and reasonably in the circumstances; and

5. Directors should also consider shareholder ratification in appropriate circumstances–although shareholders cannot ratify director decisions once the creditor duty is engaged, it is available before that point so in cases of uncertainty, it may be preferable for the directors to seek to obtain shareholder approval.

For further information or specific advice, please contact Daniel Walker.