DIVIDEND CLAWBACKS – UK SUPREME COURT RULES ON DIRECTORS' DUTY TO CONSIDER THE INTERESTS OF CREDITORS

In the present economic climate, it comes as no surprise that the spotlight is once again on the duties of directors as many companies grapple with financial pressures including rising costs and the competing demands of their stakeholders.

Section 172 of the Companies Act 2006 codifies one of the most fundamental and longstanding principles of company law: directors must act in a way that they consider, 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 has now confirmed that directors of an insolvent or potentially insolvent company owe a duty to take the interests of creditors into account, and that this may intrude upon or override the duty to act in the best interests of shareholders. This "creditor duty" was first recognised by the English and other Commonwealth courts in the 1980s, but there had been conflicting decisions on the scope of the duty and when it is engaged.

The Supreme Court confirmed that the "creditor duty" is owed to the company, rather than to individual creditors. It is now clear that creditors' interests become paramount when there is no longer "light at the end of the tunnel" and an insolvent administration or liquidation is inevitable. Directors also need to consider the interests of creditors where a company's solvency is uncertain, even if creditor interests do not wholly override shareholders. The greater the company's financial difficulties, the more the directors should prioritise creditors' interests. Where the interests of shareholders and creditors may differ, directors must consider whether shareholders or creditors have more "skin in the game".

The "creditor duty" requires proper consideration to be given to whether to pay a dividend which would otherwise comply with the requirements for a dividend under the Companies Act 2006. On the facts of this case however, the creditor duty was not engaged. At the time of the relevant dividend, the risk of insolvency was too remote.

This decision is recognised by the Court as being of "momentous" importance for company law.

Key issues

- The consideration of creditors' interests is an aspect of the director's duty to the company, rather than a free-standing duty of its own.
- Creditors' interests may need to be balanced against the interests of the shareholders – directors must weigh up who has most "skin in the game".
- The greater the company's financial difficulties, the more the directors should prioritise the interests of creditors.
- Where an insolvent liquidation or administration is inevitable, the creditors' interests become paramount as the shareholders cease to retain any valuable interest in the company and the wrongful trading provisions under section 214 of the Insolvency Act 1986 are engaged.

SUMMARY OF THE CASE

- In BTI 2014 LLC v Sequana SA [2022] UKSC 25, an English company that had (by way of a number of complex corporate transactions) inherited a contingent liability for historic river pollution declared two dividends (one in December 2008 and the other in May 2009, totalling EUR578m) to its parent company and sole shareholder, Sequana, before the liability had itself materialised.

- The dividends were challenged by AWA, the company to whom it was said the directors who had authorised the dividends owed duties, and BTI 2014 LLC was set up as a corporate vehicle for this challenge.
- In summary, the Supreme Court found that the directors were not required to consider, or to act in accordance with, the interests of creditors when paying the dividends in question. The company did not become subject to an insolvency process until some 10 years after the dividend had been paid, and insolvency was not inevitable at the time.
- The outcome of this challenge is however important for company directors more generally in confirming the nature of the obligation to consider creditors' interests, the parameters of when that obligation may be engaged and the balance that must be struck between the interests of creditors and shareholders which are determined by the stage of any financial distress.
- The judgment provides that where a company is insolvent (either on a cash flow or balance sheet basis), or bordering on insolvency, but is not faced with an inevitable insolvent liquidation or administration, the directors' duty to act in the company's interest also has to take into account creditors interests as a whole.
- Where a company is irretrievably insolvent, and there is no 'light at the end of the tunnel', then the interests of the creditors become paramount, and directors should disregard the interests of shareholders in circumstances where they are in conflict with the interests of creditors.
- Perhaps the most useful and practically focused aspect of the judgment is the reminder that in seeking to fulfil their duties, directors should ensure that they:
  - have access to reliable information about the company's financial position;
  - stay informed regarding the company's affairs;
  - maintain up to date accounting information;
  - put in place measures to provide alerts of any erosion of cash reserves or assets; and
  - take appropriate advice and training about their responsibilities.
- The judgment does not revisit the Court of Appeal's finding that an otherwise lawful dividend could be considered as a transaction defrauding creditors under section 423 of the Insolvency Act 1986 which means that dividends remain to be susceptible to challenge under this provision.

PRACTICAL LESSONS FOR COMPANY DIRECTORS

Although the Supreme Court has found that it is only when a company is irretrievably insolvent, and there is no 'light at the end of the tunnel', that the interests of the creditors as a whole become paramount, directors do need to proceed with caution when making payments away including in particular dividend distributions. So this will mean:

- Directors should ensure adequate and effective internal controls are in place regarding the financial position of the company.
- Directors should obtain legal advice as to what their duties are and how they might best discharge them in the relevant circumstances. In particular, they should be mindful of their obligation to consider the interests of creditors as a whole where the health of the company is or could be at risk.
- Specialist insolvency advice may be necessary so that directors can determine whether the company is likely to become insolvent.
- If the company is insolvent or is likely to become insolvent, directors will need to take legal advice on whether their proposed course of action might also expose them to liability for wrongful trading under the Insolvency Act 1986.
- Directors thinking of declaring a dividend should be clear about (and should document) their reasons for doing so, in case it becomes necessary to demonstrate later down the line that the relevant decisions were not taken with a view to putting assets beyond the reach of creditors.

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