The interests of creditors on insolvency at common law. Have the goalposts moved?

John Jessup

The *Sequana* decision

1. A director has a statutory duty to act in the way he considers would be most likely to promote the success of the company (Companies Act 2006, s.172; **"CA 2006"**). In doing so, he must have regard to the interests of creditors only when the director knows, or should know, that the company *is or is likely to become insolvent:* BTI 2014 LLC v Sequana S.A. [2019] EWCA Civ 112 (at [220]). A *real risk* of insolvency is not sufficient to trigger the requirement (at [215]).

2. The Court of Appeal also held that a lawfully-declared dividend is capable of amounting to a transaction defrauding creditors, and of being recovered under section 423 of the Insolvency Act 1986 (**"IA 1986"**), if it is made with the purpose of putting assets beyond the reach of creditors.

3PB's Analysis

3. **The facts.** Through a complex series of transactions, a company called AWA became liable to pay a contribution towards costs associated with cleaning up environmental damage in the United States.

4. AWA was the beneficiary of certain insurance and guaranteed investment policies in respect of that liability. Separately, AWA was also owed a debt by its parent company, Sequana, which had been loaned the proceeds of sale of AWA's assets.

5. As a result of transactions between various companies, BTI (**"the Creditor"**) had an interest in the assets of AWA.

6. AWA estimated that its liability to contribute to the environmental costs was less than the amounts it would receive under the insurance and investment policies. On that basis its directors decided that AWA was able to pay shareholder dividends to Sequana. It did so in December 2008 and May 2009, setting the payments off against Sequana's debt and thereby reducing it.

7. The Creditor's concern was that, by reducing the Sequana debt due to AWA, the directors of AWA had reduced the assets available for distribution to creditors in the event of AWA's insolvency. It challenged the dividend payments on the grounds that: (i) they beached the dividend rules under Part 23 of CA 2006; (ii) they were paid in breach of the duty of the directors of AWA to have regard to the interests of creditors under CA 2006, s.172(3); and (iii) they were transactions at an undervalue.

8. **At first instance** Rose J. dismissed the claims in respect of the December dividend, but held that the May dividend was a transaction defrauding creditors under s.423. She dismissed the alternative claim that that dividend constituted or gave rise to a breach of the directors' duty.

9. **The Court of Appeal.** Sequana appealed against the judgment under s.423, and the Creditor cross-appealed against the dismissal of the s.172(3) claim.

10. **Section 423: is a dividend "a transaction at an undervalue"?** On Sequana's appeal the Court of Appeal considered: (i) whether a dividend payment is a "transaction"; (ii) whether it had been made in return for no consideration; and (iii) whether a dividend is a gift.

11. Sequana argued that "transaction" within the meaning of IA 1986, s.423 required (except in the specific case of a gift) some element of mutual dealing between the parties, which the payment of a dividend lacked. The Court of Appeal disagreed for two reasons. First it held that a "transaction" within the meaning of the

section could include a unilateral act (at [58]-[60]). Secondly and in any event, it held that the payment of a dividend was not a unilateral act and was in fact a return on an investment (at [61]).

12. This second point dictated the answer to the question of whether a dividend payment was a "gift"; if a dividend payment is, both legally and commercially, a return on the investment made by the shareholder and part of the rights acquired when that investment was made, it would be wrong to characterise it as a gift (at [41]).

13. The question then arose whether a dividend was a transaction for *no consideration* (so that IA 1986, s.423 applied to it). Sequana relied on Lord Millett's dictum in Inland Revenue Commissioners v Laird Group plc [2003] UKHL 54, [2003] 1 WLR 2476 to argue that the payment of a dividend does not occur in isolation but as part of the contract between the company and its members under CA 2006, s.33. Sequana attempted to extend that reasoning to argue that in looking for consideration the Court should look not only at the decision to pay the dividend but at the pre-existing contractual relationship.

14. The Court disagreed. The payment of a dividend was essentially discretionary, and the fact that it was paid in accordance with the rights attached to the shares was not enough to establish that there was consideration. The terms on which a company pays a dividend do not typically provide for the company to receive any consideration (at [50]).

15. Thus the Court drew a distinction between a past relationship and the presence of consideration to distinguish between a gift, and a transaction for no consideration. There is nothing wrong conceptually with that distinction, but the Court also supported its reasoning by reference to the policy of s.423 "t*o deal with transactions deliberately designed by debtors to prejudice the interests of actual or potential creditors*". Not to apply the section to dividend payments at all (even those made with the statutory purpose in mind) would have thwarted that policy.

16. **Directors' duties to consider the interests of creditors.** On the Creditor's appeal, it sought to contend that, by declaring a dividend when there was a sufficient risk of insolvency, the directors had breached their duty to act in the best interest of the company. That raised the question: at what point does a director's duty under CA 2006, s.172(3) to "*consider or act in the interests of creditors of the company*" arise?

17. It is uncontroversial that the duty is engaged when a company is actually insolvent. It was also common ground between the Creditor and Sequana that *something* short of actual insolvency was also sufficient.

18. The Creditor argued that the duty was engaged where there was a real, as opposed to a remote, risk of insolvency. On the facts of the present case, it argued that the duty arose because the decision to issue the dividend was based on an *estimate* that AWA's liability for the environmental clean-up was less than the benefit to which it would be entitled under the corresponding policies, and that estimate could have been wrong. That argument had not found favour with Rose J. at first instance.

19. The Court of Appeal proposed four possible 'triggers' for the intervention of creditors' interests (at [213]):

    19.1. actual insolvency of the company;

    19.2. where the company is on the verge of insolvency;

    19.3. where the company is or is likely to become insolvent;

    19.4. where there is a real, as opposed to a remote, risk that the company is insolvent.

20. As to option 1, the Court reviewed the authorities and noted that while there were no instances where the Court had explicitly had to find that something less than insolvency was required it had been assumed by a great many learned Judges that that was the case. The Court of Appeal gave support to that assumption and held that option 1 was too restrictive (at [194]-[195]).

21. Option 4 as advanced by the Creditor went too far and was not based on authority. Option 2 was problematic because it implied some temporal imminence of insolvency. That would not cover the situation where, although the company was for some time able to pay its debts as they fell due, insolvency was nonetheless likely to occur and decisions taken during that time might prejudice creditors when insolvency later occurred (at [219]).

22. The Court preferred Option 3, drawing it apparently from the formulation used by Sir Andrew Morritt C. and Patten L.J. in Bilta (UK) Ltd v Nazir [2016] AC 1 amongst others: "*the duty arises when the directors know or should know that the company is or is likely to become insolvent…. In this context, 'likely' means probable, not some lower test*" (at [220]). On the facts, the Creditor had failed to establish that AWA had reached that point when the May dividend was paid.

23. The Court was influenced by the fact that the intervention of creditor interests had typically been explained by them having a 'quasi-proprietary' interest in the company, and that depended on the near prospect of the intervention of a statutory scheme of insolvency ([142]-[143], [217]). Further, since the interests of creditors and members would often be antagonistic, it was important not to stifle entrepreneurial activity by interposing the interests of creditors at an early stage. The trigger adopted by the Court of Appeal struck that balance in a similar fashion to the test for wrongful trading under IA 1986 (at [203], [218]-[220]).

Impact of the Decision

24. There does seem to be something new about this "likely to become insolvent" test as opposed to previous formulations that described situations where a company was teetering on the edge of insolvency. Counsel for the Creditor illustrated the practical difficulty: what would happen if the existence of AWA's liability turned on the outcome of a trial at which the directors had been advised they had a 60% chance of success? The Court did not engage with the example, no doubt to avoid setting any percentage-based thresholds on a point that is ultimately fact-sensitive.

25. For now, it appears that directors need to be *somewhat* more cautious than previously when deciding how to deal with companies of questionable solvency. Exactly how much more cautious is unclear. For now, directors would be well advised to produce and retain documentation showing that creditors' interests have at least been considered whenever a company's solvency looks at all doubtful.

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John Jessup is a Commercial Law barrister whose practice has a particular emphasis on Insolvency and Company Law. To view his profile click here.