Article

When Do Directors Owe Their Duties to a Company's Creditors Rather Than Its Shareholders?

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The Court of Appeal has recently ruled in *BTI 2014 LLC -v- Sequana SA & Ors* [2019] *EWCA Civ 112* that an otherwise lawful dividend may still be found to be a transaction defrauding creditors. In addition, the Court of Appeal ruled that, whilst the duty to act in the interests of creditors is engaged at a point when the company's circumstances fall short of actual, established insolvency, there however needs to be more than "a real, as opposed to remote, risk of insolvency" for the duty to be engaged.

Summary of the facts of the case

The Appellant ("**BTI**") sought to appeal a decision made by Rose J of the court of first instance that a dividend payment to the Respondent ("**Sequana**") was not paid in breach of the directors' duties to have regard to the interests of its creditors, as defined in Section 172 (3) of the *Companies Act 2006 Part 23* (the "CA 2006").

Sequana cross-appealed against the decision of the lower court on the basis that the dividend payment was not an undervalue transaction within the meaning of Section 423 (1) of the *Insolvency Act 1986* (the "IA 1986") and further, that the directors did not authorise the dividend payment with the intention to defraud creditors or otherwise prejudice their interests within the meaning of Section 423 (3) of the IA 1986.

The dividend payment which forms the heart of this appeal, referred to as "the May Dividend", was paid by the predecessor claimant company "**AWA**" to its parent company Sequana. The dividend payment was made in circumstances where AWA had ceased to trade and was on the brink of insolvency. AWA's assets included an inter-company debt owed to it by its parent company Sequana. The dividend was paid by the amount of the dividend being set off against the inter-company debt owed by Sequana.

Key issues

Lawful dividend that constitutes a transaction at an undervalue

The Court of Appeal had three questions to determine before deciding whether the dividend in question was an undervalue transaction pursuant to Section 423 IA 1986.

(1) Whether the dividend constituted a gift. The Court of Appeal held that dividends are both commercially and legally a return on the investment attached to shares for which consideration was provided by the original shareholders.

(2) Whether the dividend was a transaction for which the company received no consideration. The Court of Appeal concluded that the payment of a dividend involves the payment of funds beneficially owned by a company to its shareholders, who have a right to receive such payment only if the necessary pre-conditions (as set out in a company's articles) are satisfied. It followed that there could be no consideration to the company upon payment of dividends to its shareholders.

(3) Whether the dividend payment was a 'transaction' for the purposes of Section 423 IA 1986. The Court of Appeal considered the definition of 'transaction' within the meaning of Section 436 of the IA 1986, which is defined as "*including a gift, agreement or arrangement...*". The Court concluded that this definition is not exhaustive and that a dividend payment is capable of coming within this definition even if it was not a gift, agreement or arrangement. This interpretation was in keeping with the purpose of Section 423, which is to prohibit transactions deliberately designed by debtors to prejudice the interests of actual or potential creditors.

The Court of Appeal then turned to the statutory purpose of Section 423(3) which states that a transaction will only be considered an undervalue transaction if it was made by the person entering into such a transaction for the purpose:

(a) of putting assets beyond the reach of a person who is making, or may at some time make, a claim against him, or

(b) of otherwise prejudicing the interests of such a person in relation to the claim which he is making or may make.

The Court of Appeal considered this to be a question of fact which turned on the subjective intention of the person entering into the transaction and that this intention need not be the sole or dominant purpose. The effect of the May Dividend was that BAT Industries plc ("BAT", a claimant in the proceedings) as a potential creditor was prejudiced, as the limited assets of AWA had been diminished as a result and it could no longer call on Sequana to satisfy any debts which had been set off by the May Dividend. Section 423(3) IA 1986 was therefore satisfied as the May Dividend was paid with the intention of putting assets beyond the reach of BAT as there were insufficient assets to satisfy any claims following payment of the dividend.

Taking the above factors into consideration would the May Dividend constitute an undervalue transaction for the purpose of section 246 of the *BVI Insolvency Act 2003* ("IA 2003")?

Section 246 (1) of IA 2003 is framed in a similar language to Section 423 (1) IA 1986. That is, a company enters into an undervalue transaction with a person if the company makes a gift to that person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration. It is uncontroversial that the May Dividend would fall under the second part of this definition.

A BVI court is not required to directly consider the subjective intention of the directors in similar terms to that provided under Section 423 (3) IA 1986 when assessing whether the transaction was an undervalue transaction. However the BVI court will find itself considering the motive of the directors when entering into the transaction, as the court must consider whether the May Dividend would be considered an insolvency transaction or was entered into within the vulnerability period. A transaction is an insolvency transaction if it causes the company to become insolvent or unable to pay its debts as they fall due. Section 57 of the *BVI Business Companies Act 2004* (the "BCA") allows directors to authorise a dividend payment by resolution subject to the company's memorandum and articles and only if they are satisfied, on reasonable grounds, that the company will be able to satisfy the solvency test after payment of the dividend. Applying the facts of the case in *BTI 2014 LLC -v- Sequana SA & Ors* a BVI court would likely consider that the May Dividend was an undervalue transaction as the effect of the dividend payment meant that AWA had no available assets to satisfy the claims of BTI, a creditor.

When is the "creditors' interests duty" engaged?

In *BTI 2014 LLC -v- Sequana SA & Ors*, BTI argued that at the time of the payment of the dividend in May 2009, the directors owed a common law duty to the creditors of the company. BTI submitted that the duty arose at common law but, since the relevant part of the CA 2006 came into force, it arose under section 172(3) CA 2006. Under Section 172(1) CA 2006, the directors' have a general duty to 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 with regard to, amongst other things, the matters set out in Section 172(1) CA 2006. The general duty under section 172(1) CA 2006 has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of the creditors of the company (Section 172(3) CA 2006). Section 172(3) CA 2006 does not state the circumstances in which this requirement arises.

The duties of a director of a BVI business company are established in statute and at common law. The BCA contains provisions relating to the duties of directors and prescribes penalties for a breach of such duties. Section 120(1) of the BCA states that a director of a company, in exercising powers or performing duties, shall act honestly and in good faith and in what the director believes to be the best interests of the company. The common law duties owed by a director are of two types: (i) fiduciary duties and (ii) duties of skill and care.

The fiduciary duties of the directors of a BVI business company are owed to the company itself. In the case of a solvent company, this means that the directors will have regard to the collective interests of the members of the company. This principle is based on the fact that it is the members of the company who are entitled to the residual assets of the company following the satisfaction of the claims of all of the creditors of the company. Whilst the company is solvent, there is no significant distinction to be made between the best interests of the company and those of present and future shareholders collectively.

The BCA does not include an equivalent provision to Section 172(3) CA 2006. Under BVI law, where there is no express statutory provision on a particular issue, the courts will look to common law for guidance.

In *BTI 2014 LLC -v- Sequana SA & Ors*, the Court of Appeal held that:

"The precise terms in which the duty is said to arise differ but a frequently used formulation is that it arises where the company is "insolvent or of doubtful solvency or on the verge of insolvency and it is in the creditors' money which is at risk, in which case the interests of the creditors are paramount..."

In his conclusion of his review of the authorities, Richards LJ acknowledged that there is no decision in any English authority which makes clear that the "creditors' interests duty" is triggered by anything short of actual insolvency. However, he considered that the number of times the relevant judges had assumed that something less than actual insolvency will trigger the duty carried weight in his opinion.

The Court of Appeal rejected BTI's argument that the applicable trigger for the creditors' interests duty was a real, as opposed to remote, risk of insolvency. However, in his leading

judgment Richards LJ concluded that the creditors' interests duty may be triggered when a company's circumstances fall short of actual insolvency.

To recap the relevant statutory provisions, a company will be insolvent under BVI law if any of the following apply:

(i) the company fails to comply with a statutory demand which has not been set aside;

(ii) execution or other process issued on a judgment is returned wholly or partly unsatisfied;

(iii) the company's liabilities exceed its assets; or

(iv) the company is unable to pay its debts as they fall due, (Section 8, IA 2003).

Given the difficulty in precisely identifying the point in time when a company becomes insolvent in terms of its inability to pay its debts as they fall due, it is hardly surprising that it is similarly challenging to define the legal test for determining when the directors owe a duty to act in the interests of the creditors of the company. As noted in *BTI 2014 LLC -v- Sequana SA & Ors,* it is for good reason that the judges in previous cases have shied away from putting forward a single form of words to define the legal test. The justification for the test falling short of established insolvency is the fact that it is entirely possible for a company to descend into insolvency gradually over time, in which case the directors may not know (nor are they expected to know) that the company is actually insolvent until sometime after it has occurred.

Commentary

This is an interesting case when considered from a BVI perspective, as there is no directly corresponding provision under the IA 2003 for "*transactions defrauding creditors*". Rather the BVI has statutory provisions designed to cover undervalue transactions which will fall under the general rubric of voidable transactions per sections 402 and 246 of the IA 2003. The BVI undervalue transaction provisions have a similar legislative purpose to that of Section 423 IA 1986 which is to protect potential creditors from transactions specifically entered into to diminish the assets available to satisfy creditor claims.

It remains difficult to determine the point following which the directors need to take into account the interests of creditors, even in light of the judgment in this case. Nevertheless, the leading judgment of Richards LJ offers a helpful analysis of the approach taken by the courts in considering the question of the creditors' interests duty.

We can conclude from the judgment and other cases reviewed therein that the creditors' interests duty is triggered at a point in time when the company is close to, and before, actual and established insolvency, as determined under the IA 2003. The duty to take into account creditors' interests is engaged when the directors know or should have known that the company is or is likely to become insolvent. In this context, "likely" means probable and not some lower test. Previous cases had used descriptions such as "of dubious solvency", "in a parlous financial state" or "on the verge of insolvency" which were all considered to be formulations that were too vague to serve as the basis of a legal test for when the creditors' interests duty is engaged.

Some may view the outcome of the case as unsatisfactory in failing to resolve an issue that frequently comes to the fore when assessing potential liabilities of directors of insolvent, or potentially insolvent, BVI business companies. However, as alluded to by Richards LJ in his leading judgment, "judicial statements should never be treated and construed as if they were statutes". The question is ultimately one for the statutes (and therefore government) to resolve.

The obiter comments of Richards LJ also make it clear that further case law in this area is needed in order to address the question of the degree to which the creditors' interests take priority over those of the other stakeholders of the company, once it is established that the creditors' interests duty has arisen.

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