Enterprise
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Directors duties following BTI 2014 LLC v Sequana SA

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A look at claims against company directors following the Court of Appeal review of a challenge to the lawful payment of dividends as a transaction in breach of s.423 Insolvency Act 1986 and when the creditors' interest duty arises.

Overview

1. This talk looks at the Court of Appeal decision in the case of *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 | [2019] 2 All E.R. 784 which considered two principal issues:

    1.1. Whether the lawful payment of a dividend could be a transaction at an undervalue paid for the purpose of putting assets beyond the reach of creditors or otherwise prejudicing their interests for the purposes of s.423 of the Insolvency Act 1986, and

    1.2. The second issue concerned the duty of directors to have regard to the interests of creditors. In particular, when and in what circumstances does it arise, and does it ever arise when the directors are considering the payment of an otherwise lawful dividend?

2. As subsidiary question of the paramountcy of creditor's interest when a company is or is prospectively insolvent was also addressed briefly. All of these have the possibility of impacting on a director's duty in the "twilight" zone. The question of impending insolvency will also impact upon other office holder claims, for example a wrongful trading action.

3. As can be seen from the "Westlaw Graphical History for: BTI 2014 LLC v Sequana SA" attached to this note permission has been given to appeal to the Supreme Court, so

there may be more developments. The issues on the appeal are the same as those in the Court of Appeal:

3.1. Whether an otherwise lawful dividend may nevertheless in principle be a "transaction defrauding creditors" under section 423 Insolvency Act 1986

3.2. Whether the trigger for the directors' duty to consider creditors is merely a real risk of, as opposed to a probability of or close proximity to, insolvency.

Factual background

4. Following numerous mergers and takeovers Sequana ended up as the owner of AWA a paper manufacturer with a manufacturing plant on the Lower Fox River, Wisconsin. The river had been heavily polluted in 1950s and 1960s including by discharges from the papermill operated by AWA. Various claims relating to clean-up costs and natural resources damages resulting from pollution of the river were notified, but not quantified, over the years. The final sum was dependent on the eventual clean-up costs, a process that continues today.

5. 1n 2001 AWA sold its paper manufacturing business to API and, as a condition of that sale, indemnified the purchaser against the environmental claims, net of insurance receipts. Following the sale of API, AWA ceased to be a trading company. AWA purchased a guaranteed investment contract, called the Maris policy, to provide funds to pay for all aspects of the Lower Fox River liability.

6. Over the years AWA lent the proceeds of sale to Sequana, leading to the Sequana debt, which by 2008 amounted to €585 million. AWA's only significant obligations were its contingent indemnity liabilities for the clean-up costs. In addition to the Sequana debt its assets included historic insurance policies and the Maris policy.

7. In accordance with Part 23 of the Companies Act 2006 and the applicable accounting standards in force at the time a provision of €62.8 million was made against the contingent liabilities in AWA's interim accounts approved in December 2008.

8. AWA paid two dividends to Sequana:

    8.1. €443 million paid in December 2008
    8.2. €135 million paid in May 2009

9. At the time of the payments AWA was subject to contingent liabilities in in respect of the clean-up costs of the Lower Fox River. Its assets were:

    9.1. Investment contract with a maximum value of $250 million
    9.2. Contingent insurance claims of $100 million
    9.3. The debt owed by Sequana to AWA €585 million

10. Following the payment of the dividends the Sequana debt was reduced to €3.1 million.

11. AWA was then sold and the new board brought claims in respect of the payment of the dividends based on 3 major grounds:

    11.1. Unlawful dividend in breach of Pt 23 of the Companies Act 2006 **("could not pay claims")** brought against the directors who authorised the payments and Sequana as a constructive trustee;
    11.2. Payments made in breach of duty of the directors to have regard to the interests of creditors **("should not pay claims")** brought against the directors who authorised the payments and Sequana as a constructive trustee;
    11.3. Payments fell within s.423 IA 1986, brought by eventual assignee of the claim as a creditor and therefore a victim of the payment of the dividends.

12. Following a hearing which lasted 35 days Rose J handed down a lengthy judgment in which she:

    12.1. Dismissed all claims in relation to the December Dividends;
    12.2. In relation to the May Dividend:

12.2.1. Dismissed the 'could not pay claim' i.e. found that the May Dividend had been lawfully paid (provisions in the accounts for clean-up costs properly made and accounts properly prepared) so dividends lawfully paid;

12.2.2. Dismissed the 'should not pay' claim i.e. found that directors had not been in breach of duty in declaring the dividend;

12.2.3. Found that the May dividend had been paid in breach of s.423 IA 1986 and gave judgment against Sequana.

13. On the appeal there was:

13.1. No appeal against the findings in relation to the December Dividends

13.2. No appeal against the 'could not pay' findings in relation to the May Dividend (i.e. it was accepted that the payment of the dividend was a lawful payment);

13.3. An appeal by Sequana in relation to the finding that the payment was in breach of s.423 IA 1986

13.4. BTI appealed the dismissal of the 'should not pay' (breach of duty) claim.

14. In summary the issues for the Court of Appeal were:

14.1. In relation to the S.423 IA 1986 claim:

14.1.1. is the lawful payment of a dividend capable of challenge under s.423 IA 1986?

14.1.2. If so, in this case, was it paid with the required statutory purpose of putting assets beyond the reach of creditors?

14.2. The duty of directors to have regard to the interests of creditors:

14.2.1. At what stage it arises, and;

14.2.2. Can it apply to a lawful declaration and payment of a dividend?

Question 1: Can s.423 apply to the lawful declaration of a dividend?

15. The types of transactions to which the section applies are defined by s 423(1) IA 1986:

> *'This section relates to transactions entered into at an undervalue; and a person enters into such a transaction with another person if:*
>
> *(a) he makes a gift to the other person or he otherwise enters into a transaction with the other on terms that provide for him to receive no consideration…*
>
> *(c) he enters into a transaction with the other for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by himself.'*

16. Section 436 IA 1986 contains a non-exhaustive definition of *"transaction"* for the purposes of the Act *"except in so far as the context otherwise requires"*: it *"includes a gift, agreement or arrangement, and references to entering into a transaction shall be construed accordingly"*.

17. Therefore for a dividend to fall within the ambit of s.423 IA 1986 it would have to be a transaction at an undervalue, either gift or for no consideration. It was argued on behalf of Sequana that a dividend paid on a share was a return on the investment that the shareholder, or the original subscriber of the share, had made when the share was issued. BAT argued that it was a gift and as there was no right to a dividend

18. The Court of Appeal agreed with Sequana a dividend was not a gift but arose as a result of the bundle of rights attached to the shares, Lord Justice David Richards saying:

> *"…rights are conferred on shareholders as regards dividends by the terms of issue of the shares or by the articles, and it is pursuant to those rights that shareholders receive dividends. Those rights are attached to the shares for which consideration was provided by the original holders. Dividends are both commercially and legally a return on the investment. It would be startling to categorise dividends as gifts made by a company to its shareholders and there*

> *is no reason to think that Parliament intended the word 'gift' to carry anything other than its usual meaning."*[1]

19. The next question was whether a dividend was a transaction on terms that the payee would receive no consideration. Sequana advanced same arguments that dividend is a payment made as a result of the bundle of rights attached to the shares with consideration being provided at the time of the purchase of the shares.

20. The Court of Appeal disagreed and held that when a dividend is declared the company receives no consideration, it is the payment of funds beneficially owned by the company to its shareholders:

> *"In my judgment, it cannot be said that the company receives consideration for the payment of a dividend. It is not enough to say that the dividend is paid in accordance with the rights attached to the shares, where those rights are quite different from, for example, the right to receive interest payments on loan notes or the right to be considered for bonus declarations on a with-profits fund. If and when a company pays a dividend to shareholders, the terms of the dividend do not provide for the company to receive any consideration nor will it receive any consideration."*[2]

21. The final question was whether the declaration of a dividend is a transaction? Sequana argued that the wording of s.423 IA 1986 required some form of bi-lateral mutual dealing as emphasised by the wording in sub-s (1) which provides that *'a person enters into such a transaction with another person'*.

22. The Court of Appeal disagreed and held that to regard the payment of a dividend as a unilateral act is to narrow having regard to the rights of a shareholder which attach to the shares. David Richards LJ concluded:

> *'In my judgment, therefore, the payment of a dividend is within the scope of section 423(1), even if it cannot be said to involve an agreement or arrangement between the company and the shareholders.'*[3]

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[1] *At paragraph 41*
[2] *At paragraph 50*
[3] *At paragraph 63*

23. It should be noted in this case factually the payment of the dividend did involve a arrangement between Sequana and AWA. The formalities of the dividend process demonstrate the arrangement. The dividend was not paid in cash but, with the agreement of Sequana and was set off against the Sequana debt. Both companies executed a "cross-receipt" for this purpose and, at their meeting on 18 May 2009, the directors of AWA resolved to pay the dividend and to approve and execute the cross-receipt.

Question 2: The statutory purpose:

24. The next question addressed by the court was whether the declaration of the dividend was carried out for the statutory purpose.

25. A transaction is subject to s 423 only if the requirements of s 423(3) as to purpose are satisfied. It provides:

> *'In the case of a person entering into such a transaction, an order shall only be made if the court is satisfied that it was entered into by him 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.'*

26. This is essentially s question of fact.. The correct test is the subjective test of the payer of the dividend. The court asks itself, what did they aim to achieve. It has to be a purpose and not a consequence: : *IRC v Hashmi* [2002] 2 BCLC 489. The mechanics of the process, including the board minutes of Sequana and AWA demonstrated that the purpose of the arrangement was to ensure that Sequana was no longer exposed to the risk of a claim for the clean-up costs. In this case the Court of Appeal upheld the judge's finding that the elimination of the Sequana debt removed the legal risk by removing the debt as an asset of AWA and so putting it beyond the reach of those who

might make claims against AWA. That fell within the statutory purpose of putting the Sequana debt beyond the reach of those who might make a claim against AWA.

Breach of duty claim

27. BTI appealed against the dismissal of the 'should not pay' claim on the basis that directors owe a duty to consider the interests of creditors in any case where a proposal involves a real, as opposed to a remote, risk to creditors and that dividends can only ever benefit shareholders, can never benefit creditors.

28. The arguments turned on whether the duty to creditors ("creditors; interests duty") preserved by s.127(3) CA 2006 was engaged.

29. There was some common ground between the parties:

    29.1. First, the effect of s 172(3) was to retain the common law principles as to when the duty arises.
    29.2. Second, the duty is owed to the company, not to creditors.
    29.3. Third, there is a single threshold for when the duty arises for all decisions taken by directors. There is not a separate duty in the case of a proposed dividend.
    29.4. Fourth, the content of the duty does not vary according to the degree of risk of insolvency.
    29.5. Fifth, a failure to have regard to the interests of creditors is not of itself a breach of duty, if the directors could have reasonably concluded that the proposal should be approved even if creditors' interests were taken into account.

How close to insolvency does the company have to be?

30. There are some general points which emerge from the judgment which are of more general interest and which may impact on cases beyond the creditors' interest duty. These are:

30.1. Creditors dealing with companies voluntarily assume a risk and they can can be assumed to look after their own interests when deciding to deal with a company and there are a range of protective measures, such as the taking of security, for which they can bargain. This echoes the words if Cooke J in *Kinsela v Russell Kinsela Pty Ltd* (in liq) (1986) 4 NSWLR 722 *("Kinsela")*. Whilst this may be true, it is not reflective of the bargaining or commercial position of the vast majority of unsecured creditors in general day-to-day trading. This echoes the s

30.2. The description of limited liability as a privilege is outdated, David Richards LJ said:

> *"With respect, this is, in my view, a mistaken approach. In English law, the right to form and a register a company under the Companies Act is, in no sense, a privilege. It is a right conferred by statute in unqualified terms, and it is a right that Parliament created over 170 years ago in the public interest and for the purpose of advancing the economic well-being of the country."*

30.3. In any event the so called privilege of limited liability is not conferred on directors, the protection is afforded to shareholders who may well not be one and the same.

31. In reviewing the authorities the judge noted that the development of the duty is remarkably recent, first appearing in the decision of the High Court of Australia of *Walker v Wimborne* [1975-1976] 137 CLR 1 and in *Re Horsley & Weight Ltd* [1982] Ch 442 in the English courts.

32. The court's decision in *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250 was the starting point for the detailed consideration of the authorities. In *West Mercia* Dillon LJ approved the statement of Street CJ in *Kinsela* at 730:

> *"In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with*

> *the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration."*

33. *West Mercia* itself established two propositions:

    33.1. Firstly, the shareholders of an insolvent company cannot ratify the acts of directors taken in disregard of the interests of creditors (i.e. the Duomatic principle cannot apply), and;

    33.2. Secondly, the rationale is that, because of the company's insolvency, its assets are in a practical sense the assets of the creditors, pending its liquidation or return to solvency.

34. The real question is when the duty to have regard to the interests of creditors is triggered. As Rose J said at first instance it is unlikely that the courts have turned its mind to the precise point at which a solvent company crosses some threshold which causes the creditors' interests duty to arise. The confusion is compounded by the fact that references to creditors' interest duty are often made in the authorities where the company was clearly insolvent[4] and so the duty has arisen because of actual insolvency.

35. The Court of Appeal looked at the various expressions used by judges as the possible trigger point, including:

    35.1. 'Likelihood of loss' *Re Horlsey & Weight Limited;*

    35.2. 'Doubtful or marginal' *Kinsella*

    35.3. 'Doubtfully solvent' *Brady v Brady*

    35.4. 'Verge of insolvency' *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd [2002] EWHC 2748 (Ch), [2003] BCC 885*

    35.5. 'Whether technically insolvent or not' or 'in a dangerous financial position' *Re MDA Investment Management Ltd* [2004] 1 BCLC 217

[4] *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd), [2003] BCC 885 , Re MDA Investment Management Ltd), [2004] 1 BCLC 217 , Roberts (Liquidator of Onslow Ditchling Ltd) v Frohlich), [2011] 2 BCLC 625 , GHLM Trading Ltd v Maroo, [2012] 2 BCLC 369 and Vivendi SA v Richards, [2013] BCC 771 .*

35.6. 'A real, as opposed to a remote, risk to creditors' *Vivendi SA v Richards* [2013] BCC 771;

35.7. "…the company is or is likely to become insolvent" *Bilta (UK) Ltd v Nazir* (first instance);

35.8. "…actually or prospectively insolvent company" and "is insolvent or bordering on insolvency differ" *Bilta (UK) Ltd v Nazir* [2016] AC 1.

36. *In the Matter of HLC Environmental Projects Ltd* (in liq) [2013] EWHC 2876 (Ch) John Randall QC (sitting as a judge of the High Court) adopted the real as oppose to remote risk test, but in doing so said that he did:

> *"'not detect any difference in principle behind these varying verbal formulations'.*

37. The Court of Appeal disagreed finding that, as a matter of language, the tests are different. A real, as opposed to a remote, risk of insolvency can arise even though the company is not insolvent and may very well never become insolvent. It sets a lower hurdle than the company is likely to become insolvent.

38. In confirming that the duty arose before actual insolvency the Court of Appeal noted:

> *"There is no decision in any English authority which is clearly based on the proposition that the creditors' interests duty is triggered by anything short of actual insolvency. In all the cases, the company was insolvent, as the directors knew or ought to have known, and in few (if any) cases does this seem to have been the subject of argument. Nonetheless, the number of times that judges, many of them with considerable experience in this field, have assumed that something less than actual insolvency will trigger the duty carries weight.[5]"*

39. It said that there were four possible answers, which were not different ways of expressing the same concept:-

39.1. First, it may be when the company is actually insolvent, either on a cash-flow or balance sheet basis.

[5] *At paragraph 195*

39.2. Second, it may arise when the company is on the verge of insolvency or nearing or approaching insolvency.

39.3. Third, it may arise when the company is or is likely to become insolvent or of dubious solvency.

39.4. Fourth, where there is a real, as opposed to a remote, risk of insolvency.

40. Court of Appeal concluded that the duty may be triggered when a company's circumstances fall short of actual, established insolvency. The rationale behind this was that creditors have a prospective interests in the assets of an insolvent company. It went on to hold that the creditors' interest duty arises when:

40.1. The directors know or should know;

40.2. That the company is or is likely to become insolvent accurately encapsulates the trigger.

40.3. And in this context, 'likely' means probable.

41. Court did not decide the question of whether, after the trigger moment had been identified, the creditors' interests should be paramount. It was not an issue in this case, but having noted this David Richards LJ, but said:

> *'Where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors' interests could be anything but paramount.'*[6]

<u>Implications of the decision</u>

Directors' duties claims

42. It is worth echoing the comments of David Richards LJ that not one of the reported English decisions is based upon prospective insolvency. In all of the cases the company was actually insolvent and the directors knew, or should have known of the actual

[6] At paragraph 222

insolvency. Practically it is difficult to imagine an office holder running the risks of basing a cases on prospective insolvency alone. However, there is a perception that the bar has been raised and the test is harder than before. It will be interesting to see how this is addressed in the Supreme Court.

Ratification/Duomatic

43. A frequent defence deployed in cases of this nature is that the decision was ratified or validated by shareholders. After a few earlier cases what has since become known as the Duomatic principle was encapsulated as follows by Buckley J in *Re Duomatic Ltd* [1969] 2 Ch. 365 Ch D at 373:

> *"where it can be shown that the shareholders who have a right to attend and vote at a general meeting of the company assent to some matter which a general meeting of the company could carry into effect, that assent is as binding as a resolution in general meeting would be."*

44. In *EIC Services Ltd v Phipps* 1 W.L.R. 2360at [122].Neuberger J summarised the principle as follows:

> *"The essence of the Duomatic principle, as I see it, is that, where the articles of a company require a course to be approved by a group of shareholders at a general meeting, that requirement can be avoided if all members of the group, being aware of the relevant facts, either give their approval to that course, or so conduct themselves as to make it inequitable for them to deny that they have given their approval. Whether the approval is given in advance or after the event, whether it is characterised as agreement, ratification, waiver, or estoppel, and whether members of the group give their consent in different ways at different times, does not matter."*

45. One of the circumstances where the *Duomatic* defence is not available is where the company is insolvent or close to insolvency. As with the creditors' interest generally, this has been addressed using different language in different cases. For example in *Re: Finch (UK) Plc (in liquidation*) [2015] EWHC 2430 (Ch) HHJ Hodge said

> *"…that principle has no application once a company is insolvent or in financial difficulties such that its creditors are at risk…"*

46. There is no reason why the rationale as set out in *Sequana* should not equally apply to the application of the *Duomatic* principle and will therefore not apply where the company is insolvent or likely to become insolvent. It should also be borne in mind that it also does not apply where the company becomes insolvent as a result of the impugned transaction.

Wrongful trading

47. S.214 IA 1986 in the case of liquidations and s.246ZB IA 1986 in the case of administrations set out the test to be applied in cases of wrongful trading which is that at some time before the company entered administration or liquidation, a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid entering insolvent administration or going into insolvent liquidation.

48. The unresolved question is whether that is the same as "likely to become insolvent". Until that is resolved any office holder will be naturally wary of commencing wrongful trading proceedings, regardless of the other hurdles to be overcome.

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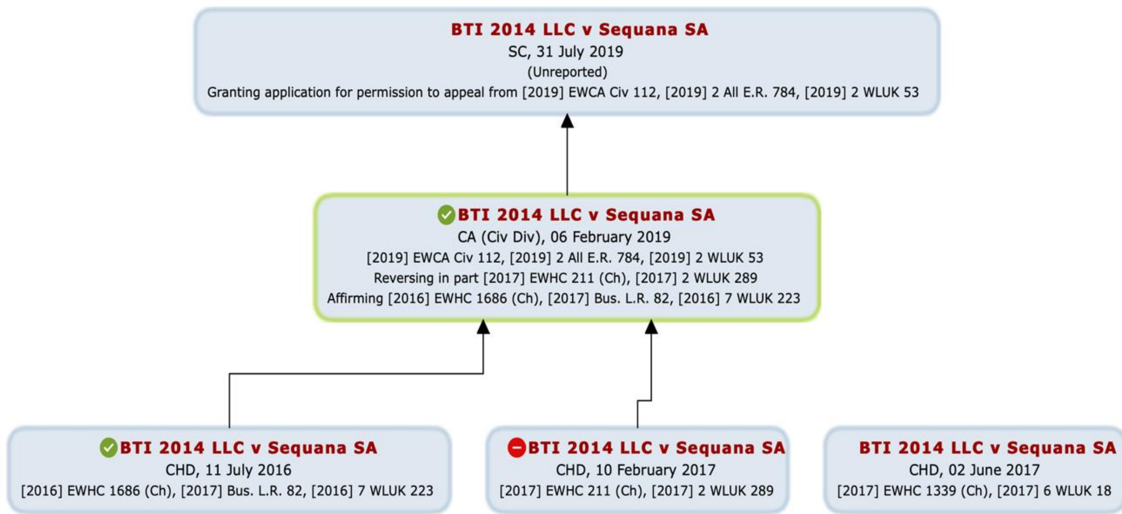

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