Sequana: creditors' interest duty and beyond

The Supreme Court judgment – amongst much else – sends out the message that directors need to stay informed, say **Christopher Brockman** and **Phillip Gale**

The Court of Appeal told us in 2019 that directors owe a duty to consider the interests of creditors "when the directors know or should know that the company is or is likely to become insolvent". Likelihood of insolvency was nice and clear, and formed the basis of misfeasance pleadings thereafter.

The decision of the Supreme Court in *Sequana* was long-awaited. It was heard on 4 and 5 May 2021, and the decision was handed down on 5 October 2022, some 17 months later. It runs to 160 pages and "raises questions of considerable importance for company law", as well as for corporate insolvency.

> **All of the members of the court appeared to support a sliding scale... The more financially distressed a company becomes, the more weight will have to be attached to creditors' interests up until they become paramount**

Whilst discussing wide-ranging and fundamental principles, the actual decision of the Supreme Court is arguably quite narrow. First, it confirms that a duty to consider creditors' interests exists (it had been ambitiously argued by the respondent that there was no duty at all). Second, it confirms that an otherwise lawful dividend (i.e. one which complies with Part 23 of the Companies Act 2006) can nevertheless amount to a breach of duty in appropriate circumstances. Third, and most importantly, it decides that a real risk of becoming insolvent is insufficient to engage the duty to consider creditors' interests.

No longer authoritative

In other words, the Supreme Court decided when the duty did not arise, but did not decide when it did. The Court of Appeal test of likelihood of insolvency is therefore no longer authoritative. Lord Reed explicitly poured cold water on the likelihood trigger (at [89]), but preferred to express no view as to the correct test. Lord Briggs (with whom Lord Kitchin agreed) was only slightly less circumspect, preferring "a formulation in which either imminent insolvency … or the probability of an insolvent liquidation" were sufficient triggers (the conclusion at [203]).

Nevertheless, Lord Briggs observed that he reached "substantially the same conclusions" about timing as Lord Reed. Lord Hodge agreed with both Lord Reed and Lord Briggs. Finally, Lady Arden thought that only "irreversible insolvency" would suffice ([311]), but that was in the context of the duty being one where creditors' interests overrode those of shareholders.

Given the differing treatment of the timing question in the Supreme Court, practitioners could be forgiven for preferring the certainty of the likelihood test. However, the sense that the Supreme Court has taken a step backwards for certainty can be overdone. All of the members of the court appeared to support a sliding scale when talking about the 'content' of the duty. The more financially distressed a company becomes, the more weight will have to be attached to creditors' interests up until they become paramount.

In that sense, the question of a single trigger is inapposite and it is perhaps better to collapse the distinction between trigger and content. This means that when a company is not financially distressed, the interests of creditors and shareholders are aligned. Even when there is a real – as opposed to a remote – risk of insolvency, "the interests of creditors will not require separate consideration", Lord Reed at [83]. After that, creditors' interests do require to be considered as part of the overall duty to promote the success of the company. The weight to be attached to creditors' interests increases as the company's financial position worsens. At a certain point, variously described by the court as "imminent insolvent liquidation", "irreversible insolvency", or there being "no light at the end of the tunnel", creditors' interests would become predominant.

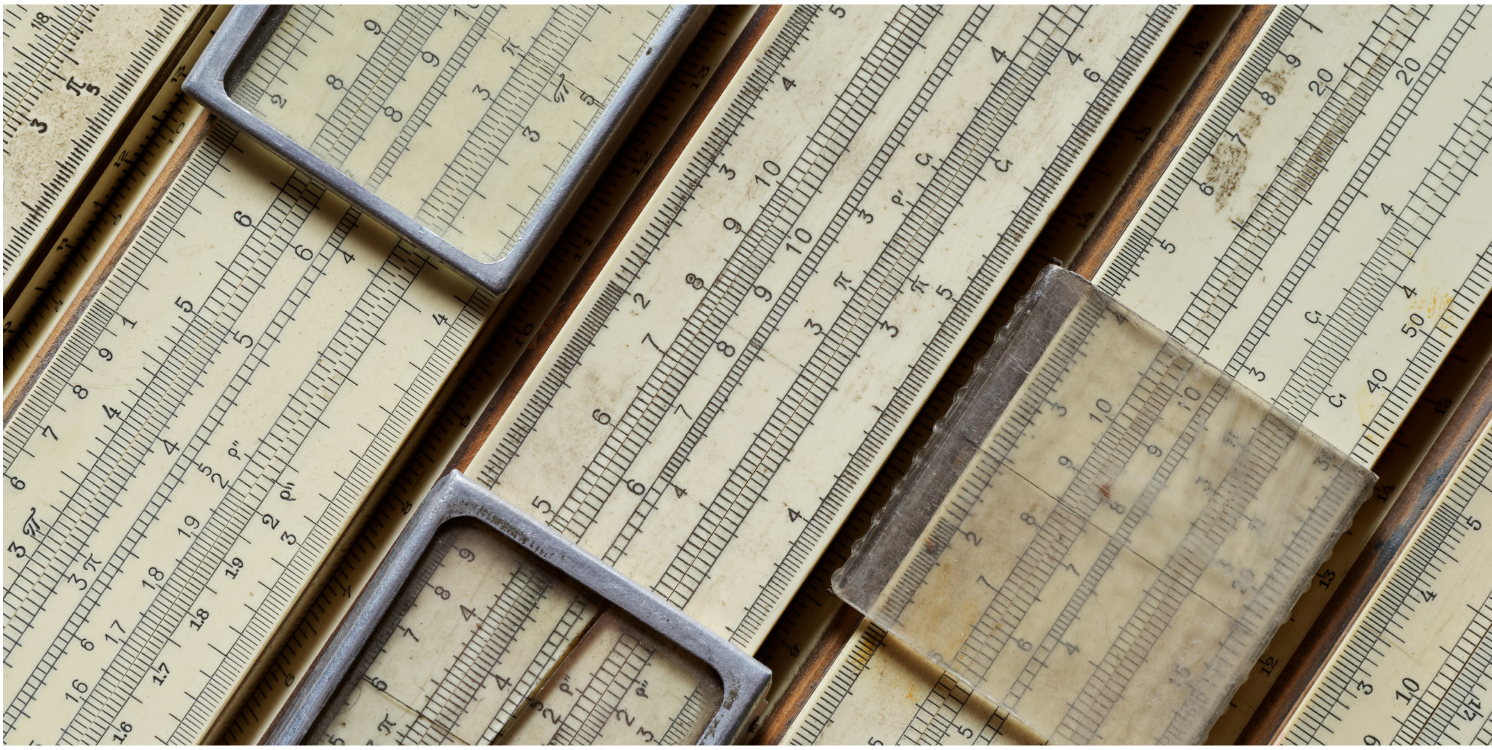
> **At a certain point, variously described by the court as "imminent insolvent liquidation", "irreversible insolvency", or there being "no light at the end of the tunnel", creditors' interests would become predominant**

Proving breach has probably become harder

If this is the best reading of *Sequana*, the range of circumstances in which the duty comes into play has potentially been widened – "financially distressed" appears more expansive than "insolvent or likely to become insolvent". However, proving breach has probably become harder. The Court of Appeal considered that "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" ([222]). It is clear that the Supreme Court thought that the time when creditors' interests became paramount was much later than actual insolvency

> **Office holders and ATE insurers should review any current cases where they pleaded and relied upon the Court of Appeal's likelihood test**

Editor editor@r3.org.uk



and, indeed, closer to the wrongful trading standard. Making out breach will be harder still where there is evidence that the directors actually considered creditors' interests before taking the decision in question.

So, to use a worn out phrase, every case turns on its facts. What this does mean is that office holders and ATE insurers should review any current cases where they pleaded and relied upon the Court of Appeal's likelihood test. Whilst – as noted by Lord Justice David Richards in the Court of Appeal – in reality, actual insolvency has been proven in all cases decided up until then, the likelihood test is frequently pleaded, often as an alternative head of claim. There had been no decision in any English authority which is clearly based on the proposition that the creditors' interest duty is triggered by anything short of actual insolvency and that the director either knew or should have known that the Company was insolvent. It follows that the Supreme Court's judgment is unlikely to have a huge impact on current cases, but that does not mean they should not be reviewed. A sliding scale also is sensible, as it means the creditors' interest will intrude in a director's decision-making process to a greater extent as the financial situation worsens; the creditors' interest duty has never been a one size fits all.

Another point that the Supreme Court addressed was the requirement of directors to keep themselves sufficiently informed about the company's business to enable them to carry out their duties. The message which the judgment sends out is that directors should stay informed. As Lady Arden emphasised (at [304]), directors should always have access to reasonably reliable information about the company's financial position. The company is responsible for maintaining up to date accounting information itself, though it may instruct others to do so on its behalf. Directors can and should require the communication to them of warnings if the cash reserves or asset base of the company have been eroded so that creditors may or will not get paid when due. It will not help to resign if they remain shadow directors.

> **“It is now clear that a director cannot escape liability by saying they did not know; they will have to establish that they took all reasonable steps to keep themselves informed and that they could not have discovered the fraud”**

Interestingly, Lady Arden also indicated that self-education about the role of a director is a factor the court may consider, saying: “In addition, directors can these days without much difficulty undertake appropriate training about their responsibilities, and about the penalties if they disregard them.”

At [280] Lady Arden also addressed the question of knowledge where the insolvency was caused by outside factors, such as fraud. In that situation, she said that if a director contends that they were not aware of the fraud then the onus should be on them to show that they should be excused. This shifts the onus onto the director to show why they should not be held liable where they were unaware of a fraud.

So, in cases where the fraud was external, it is likely to be easier to escape liability than where the cause was internal. Whilst this has been a developing area of law, it is now clear that a director cannot escape liability by saying they did not know; they will have to establish that they took all reasonable steps to keep themselves informed and that they could not have discovered the fraud.

Ignorance of the law has never been a defence. *Sequana* makes it clear that a director's ignorance of either a company's financial position or of the extent of their duties is not a defence either.

Christopher Brockman and **Phillip Gale** are barristers at Enterprise Chambers