Corporate duty to creditors: The UK Supreme Court's lost opportunity to adopt a more stakeholder-oriented perspective.

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This article offers a brief commentary on the October 2022 UK Supreme Court decision BTI 2014 LLC v Sequana SA [2022] UKSC 25 that focused on corporate directors' duties to creditors. The article argues that the judiciary has lost a golden opportunity to be innovative and interpret the law adopting a more stakeholder-oriented perspective leading directors toward more responsible behavior. In particular, the Supreme Court affirmed that the interests of creditors acquire autonomous relevance and require separate consideration only when the company's insolvency is "imminent" or its insolvent liquidation or administration becomes "probable." As a result, the Court has excluded the relevance of any other situation that may otherwise indicate a "risk of insolvency". This approach appears to be reactionary in that it is merely based on the traditional assumption that company law has to encourage high-risk investments that otherwise would never be made. Such a decision appears worrisome in that it does not try to foster a more responsible approach to risk and corporate behavior disregarding the lessons learned and the burning issues that emerged from the countless corporate collapses we have experienced in the last two decades as well as the financial crisis of 2008.

In October 2022, in the decision [*BTI 2014 LLC v Sequana SA* [2022] UKSC 25] the U.K. Supreme Court had the chance to re-consider the vexed question relating to the existence of a "creditor duty."

In what could be considered a reactionary judgment, the Court failed to adopt a more stakeholder-oriented approach consolidating the shareholder supremacy and managerial power's approaches to corporate governance.

The crucial question the Supreme Court had to solve in the case at issue was (if and) when managers, apart from shareholders' interests, should take into consideration creditors' interests when they carried out their business practices. This is known as the directors' "creditor duty".

The existence of creditor duty cannot be taken for granted. Not surprisingly, in jurisdictions where managerial power prevails, such a duty is not recognized. In *North American Catholic Educational Programming Foundation v. Gheewalla*, the Delaware Court of Chancery held, and the Delaware Supreme Court affirmed, that creditors do not have the standing to assert direct breach of fiduciary duty claims during insolvency or in the zone of insolvency (Ruben, 2010, 333). Some authors suggest that the doctrine of creditor duty should be abolished in that it disrupts the basic corporate equilibrium because, when it is triggered, "duty shifting requires corporations to act in the interests of creditors while the key mechanisms of the underlying governance system continue to direct managers to act instead in the interests of shareholders." (Hu and Westbrook, 2007, 1349).

However, creditor duty plays a fundamental role in the corporate world, and it is relevant in that it fosters more responsible corporate practices. Directors may tend to act as "risk takers" having a high-risk propensity even when they are managing what appears to be a failing business. For instance, in an attempt to let the company survive, they could take out additional loans even if the firm is already burdened with substantial debt. As Metzger highlighted, when directors think about the zone of insolvency and these forms of expanded fiduciary duties, they are interested in what could be the consequences of their actions and if they could be considered accountable. The basic question of a director would be "Wait, what are the actual situations in which directors have been found liable when a case has been tried on the merits for a breach of these kinds of expanded duties?"; and as we know, these cases are really few (Callison et al., 2007, 258).

Under English Company Law, the Company Law Act 2006, in its Chapter 2 that lists the "general duties of directors," affirms in section 172(1) that the "director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole." It is clear that English law considers that directors serve the interest of the company (and its shareholders) whereas other stakeholders' interests stay, ordinarily, in the background.

Such a view does not give recognition to the most advanced theories of corporate governance that adopt a stakeholder-oriented approach (such as the stakeholder theory) as a response to countless instances of irresponsible corporate behavior caused by directors' decisions characterized by the tendency to take imprudent risks.

However, at least for creditors' interest, the Company Law Act 2006 has left the door partially open when, in section 172(3), it states that "the duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company."

Through this norm, the legislature has implicitly acknowledged the development of common law in this area. However, no precise approach has been adopted and the vagueness of this provision has generated an intense debate about its real significance. More specifically, section 172(3) does not law down any guidance as to when "directors should shift their attention away from the company qua body of shareholders towards the interests of creditors" (Dignam and Lowry, 2014, 356).

In the English legal system, the creditor duty was articulated for the first time in 1987, in *West Mercia Safetywear Ltd v. Dodd* [1988] BCLC 250. A judicial decision that was inspired by the earlier Australian authority *Kinsela v. Russell Kinsela Pty Ltd* [1986] 4 NSWLR 712.

The main problem that arose from the adoption of creditor duty has been to determine when the duty arises, that is to answer the question as to when creditors' interests fall to be considered by directors as part of those company interests.

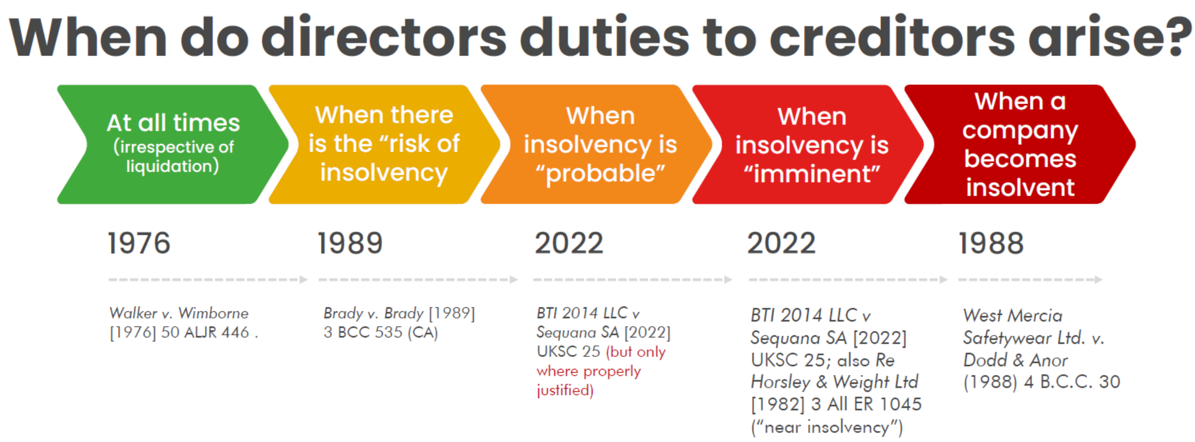
Generally speaking, before the intervention of the Supreme Court, it was possible to distinguish three different positions, which use three different thresholds from the one that leaves directors the amplest room for maneuver and the least margin of safeguards for creditors to the one that offers the most effective safeguards for creditors:

1. **When a company becomes insolvent** the interests of creditors are company interests. This threshold emerged in *West Mercia Safetywear Ltd. v. Dodd & Anor* (1988) 4 B.C.C. 30: "Where a company is insolvent, a director's duty to act in the best interests of the company includes a duty to protect the interests of the company's creditors."
2. Creditors' interests transform into company interests **as the company approaches insolvency or when insolvency is threatened**. Several cases extend the principle to incipient insolvency or even threatened insolvency. For example, the Court of Appeal in *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 stated that "near insolvency" was a precondition of creditor interests being subsumed within company interests. This is echoed in *Brady v. Brady* [1989] 3 BCC 535 (CA): "Where the company is even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone."

3. The interests of the company include those of creditors, and directors should bear in mind creditors' interests **at all times**. From this perspective, insolvency per se is no precondition to consideration of creditors' interests. The High Court of Australia in *Walker v. Wimborne* [1976] 50 ALJR 446 indicated that creditors' interests should be considered even before insolvency because "those interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent." Thus, creditors' interests could always be relevant given the theoretical possibility of future insolvency.

As it clearly emerged, judges failed to state clearly when the duty arises or what state of mind or knowledge renders the director potentially liable. For many years, the precise boundaries of the creditor duty remained to be settled and its very existence was open to challenge.

With the judicial decision *BTI 2014 LLC v. Sequana SA*, the Supreme Court offered its view and solution to this vexed question. Basically, on the one hand, the judiciary has recognized the existence of a "creditor duty" but, on the other, it decided that a very high threshold should be met in order to trigger such a duty. In particular, the Supreme Court affirmed that the interests of creditors acquire a discrete significance from those of shareholders and require separate consideration, only when the company's insolvency is imminent (i.e., "an insolvency which directors know or ought to know is just round the corner and going to happen") or its insolvent liquidation or administration becomes probable. However, the judges offered only a narrow interpretation of the probable-insolvency trigger stating that "it will not be in every or even most cases when directors know or ought to know of a probability of an insolvent liquidation, earlier than when the company is already insolvent." Such an approach does not take into consideration the level of information asymmetry that is present in the corporate world as well as the fact that companies fundamentally are secretive institutions (Chomsky, 1999, 133). Also, it does not take into consideration that in the vast majority of cases creditors cannot anticipate everything that might happen, they cannot safeguard themselves using specific covenants, and they cannot identify pricing risk in a completely accurate way (Callison et al., 2007, 268).



In practice, the Supreme Court has distinguished between a scenario where liquidation is "probable" from all other situations where the company faces a risk of insolvency whatever significance it may have. Following the logic of the court, the decision is based on the circumstance that otherwise directors should become risk-averse where the company is sailing in rough seas with a potential risk of liquidation present. From the court's perspective, in such a moment, a risk-taking director could save the firm and avoid liquidation. This approach appears to be reactionary in that it is merely based on the same assumption that led to the adoption of the concept of limited liability as we know it, i.e., that company law has to encourage high-risk investments that otherwise would never be made. This appears to be a worrisome approach in that it disregards the lessons learned and the burning issues that emerged from the countless corporate collapses we have experienced in the last two decades as well as the financial crisis of 2008.

Finally, it is interesting that the Supreme Court justifies such an approach considering, among other things, the Covid-19 situation. In that regard, the Court affirmed that "The present Covid-19 pandemic provides a practical template upon which the excessive remoteness of this trigger may be demonstrated. In March 2020 it must have appeared to the directors of innumerable companies in the travel and hospitality businesses that they faced a real risk of insolvency. During the two years which followed, some have no doubt become permanently insolvent (with no light at the end of the tunnel). Others have become temporarily insolvent, but kept open a realistic prospect of recovery […] Only for the companies in the first (permanently insolvent) group will their creditors have become entitled (actually or inevitably) to share in the proceeds of their winding-up or administration." However, as the same Supreme Court admits, because of its exceptional nature, the pandemic should not be regarded as a reliable guide to establishing a general principle of law.

In conclusion, in order to safeguard corporate profitability, in *BTI 2014 LLC v Sequana SA* for the umpteen time the judiciary has lost a golden opportunity to be innovative and interpret the law in a more stakeholder-oriented perspective leading directors towards more responsible behavior. As Freeman brilliantly affirmed "despite the prophetic words of Berle and Means, scholars and managers alike continue to hold sacred the view that managers bear a special relationship to the stockholders in the firm… 'the law of corporations' and other protective mechanisms … are thought to reinforce the assumption of the primacy of stockholders" (Freeman 2001, 38).

It follows a series of select excerpts of some of the most interesting (and potentially controversial) passages from the Supreme Court's judicial decision:

[Para 89] "I am not inclined to agree with the view expressed by … [the] Court of Appeal (paras 213-220) that it is sufficient that the company is likely to become insolvent at some point in the future. As it seems to me, such a likelihood may objectively exist before the interests of shareholders and creditors are in practice liable to diverge, so as to require the interests of the latter to receive separate consideration."

[Para 96] "the interests of creditors acquire a discrete significance from those of shareholders, and require separate consideration, once the company's insolvency is imminent, or its insolvent liquidation or administration becomes probable."

[Para 111] "I conclude that English law recognises a rule, which I have referred to as the rule in West Mercia, according to which the interests of a company, for the purposes of the director's duty under the common law to act in good faith in its interests, should in some circumstances be understood as including the interests of its creditors. I also conclude that the rule in West Mercia has been preserved by section 172(3) of the 2006 Act. However, I am satisfied that the rule does not apply merely because the company is at a real and not remote risk of insolvency at some point in the future. It therefore does not apply in the circumstances of the present case."

[Para 173] "practical common-sense points strongly against a duty to treat creditors' interests as paramount at the onset of what may be only temporary insolvency, still less at some earlier moment, such as when insolvency is imminent. Why should the directors of a start-up company which is paying its debts as they fall due but is balance sheet insolvent by a small margin abandon the pursuit of the success of the company for the benefit of its shareholders? And why should the directors, faced with what they believe to be a temporary cash-flow shortage as the result of an unexpected event, like the present pandemic, give up the pursuit of the long-term success of a fundamentally viable, balance sheet solvent, business for the continuing benefit of shareholders?."

[Para 174] "If the fact of insolvency always and immediately rendered the interests of creditors paramount, then directors would be likely to decide, or to be advised for their own protection, to cause the company immediately to cease trading, because that course would usually minimise the risk of further loss to creditors, whereas continued trading with a view to a return to solvency might increase that risk. It would in my view be wrong for the common law to impose that fetter on the directors' business judgment."

[Para 191] "I would however reject real risk of insolvency as the appropriate trigger for the engagement of the creditor duty. My main reason for doing so is that it rests upon an unsound principle. It assumes that creditors of a limited company are always among its stakeholders, so that once the security of their stake in the company (i.e., their expectation of being repaid in full) is seen to be at real risk, there arises a duty of the directors to protect them."

[Para 193] "But a real risk of insolvency is at one very large remove. It is simply too remote from the event which turns a creditor's prospective entitlement into an actual one. When real risk is distinguished from probability (as it must be for present purposes) insolvency itself is by definition unlikely, and insolvent liquidation may only be a remote possibility."

[Para 194] "I consider that a trigger of that degree of remoteness is insufficient in principle to displace the ordinary general duty of directors to promote the success of their company for the benefit of its shareholders."

[Para 199] "In my view any trigger earlier than actual insolvency [such as probable insolvency and imminent insolvency] needs clear justification."

[Para 200] "'imminent' insolvency implied a very short period in terms of time, whereas a probability of insolvency might affect a company for a considerable time, during which creditors might well be prejudiced by decisions taken without consideration of their interests."

[Para 203] "I would prefer a formulation in which either imminent insolvency (i.e., an insolvency which directors know or ought to know is just round the corner and going to happen) or the probability of an insolvent liquidation (or administration) about which the directors know or ought to know, are sufficient triggers for the engagement of the creditor duty. It will not be in every or even most cases when directors know or ought to know of a probability of an insolvent liquidation, earlier than when the company is already insolvent. But that additional probability-based trigger may be needed in cases where the probabilities about what lies at the end of the tunnel are there for directors to see even before the tunnel of insolvency is entered."

Select Case Law

- *Brady v. Brady* [1989] 3 BCC 535 (CA)
- *BTI 2014 LLC v. Sequana SA* [2022] UKSC 25
- *Kinsela v. Russell Kinsela Pty Ltd* [1986] 4 NSWLR 712.
- *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* - 930 A.2d 92 (Del. 2007)
- *Re Horsley & Weight Ltd* [1982] 3 All ER 1045
- *Walker v. Wimborne* [1976] 50 ALJR 446
- *West Mercia Safetywear Ltd v. Dodd* [1988] BCLC 250.

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