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Why accountants must heed creditor duty decision

BUSINESS

A UK Supreme Court ruling confirms a duty of directors to creditors — and it has implications for Australian accountants.

By Trevor Withane•03 January 2023•6 minute read

This is an important update in the Australian corporate and insolvency law context because, in *BTI 2014 LLC v Sequana SA and others* [2022] UKSC 25, the UK Supreme Court (its highest) confirmed the existence of a duty owed by directors to creditors in certain circumstances (creditor duty).

Before this decision, there was some uncertainty as to whether the directors of a solvent company owed any duties to creditors rather than solely to the company itself and its shareholders. This decision has provided much-needed clarity — especially at a time of global economic uncertainty and an expected increase in insolvent Australian companies.

One implication of this case may be that creditors who are not paid in full through the liquidation of the insolvent estate, may be able to pierce the corporate veil and sue directors for their loss. Accountants should be mindful to advise their directors and company clients of this expansion of potential director liability. Further, accountants may also wish to bring this potential avenue for recovery to the attention of their clients who may be creditors of an insolvency company.

The facts

The directors of a company, AWA, caused it to pay a dividend of €135 million to its only shareholder at a time where, while the company was solvent, there was a real risk that it might become insolvent at some point in the medium-to-far future.

The company became insolvent nine years later. The Appellant, BTI (2014) LLC, who was an assignee of the company's claims, sought to recover the €135 million dividend on the ground that the directors' decision to distribute the dividend was a breach of their duty to take into account the interests of creditors.

The decision

In this case, the court held that the creditor duty is extended to the directors' decision to pay a dividend, notwithstanding the distribution of the dividend was otherwise lawful. However, the precise nature of the duty is a question of fact and degree which needs to be "balance[d] … against shareholders' interests where they may conflict". Factors that are relevant in determining whether the duty is said to arise include but are not limited to:

- whether a proposed course of action will enable the company to return to a solvent state;
- who, as between shareholders and creditors, risk the greatest damage if that course of action does not succeed; and
- the interests of the general body of creditors as a whole, rather than of any individual creditors.

It is also important to note that the closer a company is to insolvency, the greater the weight that must be accorded by directors to the interests of creditors.

When creditor duty is engaged

On the facts of this case, the court held that the creditor duty was not engaged because the company was neither insolvent nor anywhere near insolvent at the time the dividend was paid — the company did not enter liquidation until nine years after the payment of the dividend.

However, the more significant principle of law which emerged from the judgement is that in the view of the majority, the creditor duty is enlivened where there is:

"Either imminent insolvency (ie: an insolvency which directors know or ought to know is just around the corner and going to happen) or the probability of an insolvent liquidation (or administration) about which the directors know or ought to know".

The creditor duty will not be enlivened in cases of mere temporary cash flow insolvency as opposed to balance sheet insolvency. In other words, the "trigger for creditors' interests to override those of shareholders … [will not be pulled] where there is still 'light at the end of the tunnel'." However, in the Australian context, it must be remembered that under s 95A of the *Corporations Act 2001* (cth) the primary solvency test is based on cash flow, not balance sheet solvency. That is, a company which cannot pay its debts as and when they fall due is insolvent.

Practical takeaways

- Directors (and accountants who assist them) should always ensure that they are on top of their company's financial health, as this will have a material impact on the weight to be accorded to creditors' interests. The greater the company's financial difficulty, the more important the interests of creditors become. A failure by directors to keep themselves informed of the company's financial status may well itself be a breach of directors' duties.
- As a matter of good practice, make sure to be cautious and take creditor interests into account when making decisions. The fact-based nature of the inquiry means that a court may be more inclined to absolve a director who has directed his mind to the interest of creditors — even when the director does not suspect insolvency. Accountants should therefore be vigilant against potential threats to creditors' interests when the company's financial health is precarious and must alert directors as soon as they discover any such threats.
- Directors should document the steps taken to evaluate the creditors' interests and how their decision took such interests into account. Accountants, who often assist directors with these issues, may consider engaging collaboratively with directors and their legal representatives in creating documents in a way that is shrouded in legal privilege.
- Check that any D&O insurance policy is up-to-date and fit-for-purpose, as it may not have coverage for breach of the creditor duty.

- Accountants, lawyers and insolvency practitioners should bear the creditor duty in mind when advising boards of companies in financial difficulty. An adviser who fails to advise a director about the creditor duty, may itself be liable to the director should the director suffer loss.

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