IN FOCUS

Pensions law and the *Sequana* decision: directors' duties and pension debts

By Tom Robinson

Introduction

The Supreme Court's decision in *BTI 2014 LLC v Sequana* [2022] UKSC 25 has been analysed at length by company law and insolvency specialists. It also holds points of interest for pensions practitioners, which this article seeks to explore.

In summary:

a. The *Sequana* case concerned a company with contingent liabilities of uncertain amount for future environmental clean-up costs, and matching assets (an insurance portfolio) of uncertain value. As a result there was a "real risk", though not a probability, that the company might become insolvent in the future.

b. This is not dissimilar to the position of a sponsor of (or employer in) a DB pension scheme, which is contingently liable for a deficit in the scheme that might arise (or increase beyond the value of the sponsor's assets) depending on future movements in asset values and the scheme's liabilities.

c. In Sequana the Supreme Court held that directors of a company that is at "real risk" of insolvency were not obliged (as part of their duty to the company under s.172 of the Companies Act 2006 to act in what they considered, in good faith, most likely to promote the success of the company for the benefit of its members as a whole) to have regard to the interests of the company's creditors.

d. However if the company reaches the point of "imminent" insolvency or "bordering on insolvency", that duty does require the directors to have regard to the interests of

the company's creditors as a whole. This is sometimes called the "creditor duty", although it is not owed to creditors but is owed to the company.

e. That is of obvious relevance to directors of sponsors, who will be obliged to take account of the interests of the pension scheme (along with other creditors) when the tipping point is reached. But what does that mean in practice? What about directors of guarantors of pension debt?
f. It is also of relevance to trustees of pension schemes who might receive sums from the sponsor at a time it is "bordering on insolvency", or who might object to the company's actions at such a time. What issues arise for them?

The Facts

In May 2009 the directors of a company called AWA caused it to declare a €135m dividend to its sole shareholder, Sequana SA. The dividend was lawful, in that it complied with all of the requirements of Part 23 of the Companies Act 2006 and with the common law maintenance of capital rules.

The dividend was declared and paid at a time that AWA was solvent on a balance sheet and cash flow basis. These are the two forms of insolvency recognised at law, in particular as thresholds for the entry into an insolvency process (s.123(1)(e) and s.123(2) of the Insolvency Act 1986). The "balance sheet" basis simply means that the value of the company's assets is less than the amount of its liabilities. The "cash flow" basis means that the company is unable to pay its debts as they fall due. It is important to distinguish a state of insolvency from being in an insolvency process (such as insolvent liquidation or administration). The former may not lead to the latter.

As at the time of the dividend AWA had (1) long term pollution related contingent liabilities, which were uncertain in amount, and (2) an insurance portfolio of uncertain value. Hence there was a "real risk" of AWA becoming insolvent at a date in the future that was not imminent and was uncertain.

Almost ten years later, in October 2018, AWA entered insolvent administration.

Two claims were advanced:

(1) AWA's main creditor (BAT Industries plc) challenged the dividend as a transaction defrauding creditors within section 423 of the Insolvency Act 1986. This section allows a "victim" of the transaction to challenge it as a transaction at an undervalue that was entered into for the purpose of prejudicing the interests of creditors, e.g. putting assets beyond their reach. This claim succeeded, but *Sequana* then entered insolvent liquidation so the victory was Pyrrhic;

(2) The Claimant (BTI 2014 LLC, as assignee from AWA and therefore advancing the company's claim) claimed against AWA's directors to recover the value of the dividend on the grounds that the decision to distribute it breached the "creditor duty". This claim failed in the High Court and Court of Appeal; they both held that the "creditor duty" had not been triggered by May 2009.

The Supreme Court

The decision in the Supreme Court is the longest yet handed down by that court, at 160 pages. The Respondents (the directors) argued that the creditor duty did not exist as a matter of law, alternatively that it had not been triggered by the "real risk" of insolvency that existed for AWA in May 2009.

The Supreme Court (Lord Reed, Lord Hodge, Lord Briggs, Lady Arden and Lord Kitchin) all agreed that the appeal should be dismissed. The Court held that the "creditor duty" was part of English common law, that the payment of a dividend that was lawful under the Companies Act 2006 could still breach the "creditor duty", but that the duty was not triggered merely by a "real risk" of insolvency. They went on to discuss, obiter, when the duty did arise and what its content was. As to these issues:

(1) Lord Briggs, Lord Kitchin and Lord Hodge considered that the creditor duty would arise if the directors knew or ought to know that the company was insolvent or bordering on insolvency, or an insolvent liquidation or administration was probable. Lord Reed and Lady Arden agreed, save for the issue of "if the directors knew or ought to know": they

considered that the question of the directors' knowledge should be left for full submissions on another occasion. Lord Reed was "at present inclined to agree" with the conclusion in *Bilta (UK) Ltd v Nazir (No 2)* [2016] AC 1 at [123] that the duty is engaged where the company is insolvent or bordering on insolvency, or where insolvent liquidation or administration is probable (at [88]).

(2) As for the content of the duty, Lady Arden said that it required the directors to consider and not materially harm creditors' interests. The other members of the court described it as a duty to consider creditors' interests, not necessarily treating them as paramount until an insolvency process is unavoidable.

The pensions context: (1) those responsible for the employer's pension debt

AWA's financial position in May 2009 has several similarities to that of the sponsor of a DB scheme. AWA's liability for environmental clean up costs was uncertain and contingent, and the assets available to meet it were of uncertain value. AWA's balance sheet showed a solvent situation, but that could change due to circumstances outside its control (a fall in asset values, or a rise in liabilities, or both). So too for a sponsor of a DB pension scheme in relation to its contingent liability for a debt under section 75 of the Pensions Act 1995, and for any guarantor of a sponsor's section 75 debt.

The Supreme Court's decision offers some support for directors of sponsors or guarantors in these circumstances. That is not only because of their conclusion that a "real risk" of insolvency is not enough to trigger the creditor duty. It is also because of the statements, particularly by Lord Briggs, that even once the creditor duty is engaged directors are not obliged to treat creditors' interests as paramount until insolvent liquidation is inevitable. Thus a temporary state of insolvency (balance sheet or cash flow) does not mean creditors' interests become paramount. It does not require the cessation of trade in order to minimise risk to creditors. As Lord Briggs put it:

"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?" (at [173]).

However there are obvious but real difficulties in identifying when a state of temporary inability to pay debts has become permanent, or when a company that is balance sheet insolvent by even a small margin has become unable to return to solvency.

This uncertainty is a consequence of the Court's conclusion that once the creditor duty is triggered, the content of it is extremely fact sensitive. Thus the analysis begins with:

(1) a solvent company, perhaps with a real risk of insolvency, for which the creditor duty is not engaged at all.

(2) It proceeds to a company where insolvency is probable or likely, where the creditor duty is not engaged either.

(3) However if insolvency is imminent, or the company is bordering on insolvency, then the duty is engaged as long as the directors knew or ought to know that was the case (per Lord Briggs, Lord Hodge and Lord Kitchin). It is also engaged if an insolvent liquidation is probable.

(4) The company's entry into an insolvency process is inevitable.

Yet even then the analysis must distinguish between situation (3), where the duty is engaged but only requires creditors' duties to be taken into account, and (4) cases where the company's entry into an insolvency process is inevitable, so that creditors' interests are paramount. Between (3) and (4) lies a sliding scale, where the degree of weight to give creditors' interests depends on who, as between creditors and shareholders, bear the risk of the greatest damage if the company fails (at [176]).

All of this will mean directors of sponsors, and of guarantors of s.75 debts for a scheme of a material size, are likely to want frequent input as to the amount of a scheme's liabilities, the values of its assets, and the values of other assets available to meet a scheme's deficit. Such input

may show that the company has moved from situation (2) to (3), but may show movement in the other direction or a dramatic change. As Lady Arden noted "*The progress towards insolvency may not be linear and may occur not as a result of incremental developments but as a result of something outside the company which has a sudden and major impact on it*" (at [303]). Movements in pension deficits may well meet that description.

The pensions context: (2) Trustees of the pension scheme

Two quite different scenarios should be considered under this heading. The first is the trustee as recipient of property from the employer. What risks do recipients run if the contributing company subsequently enters an insolvency process? The judgments in *Sequana* stress that the creditor duty does not conflict with provisions under the Insolvency Act 1986 allowing a liquidator or administrator to unravel some transactions entered into before a company enters an insolvency process. Thus if the employer enters a transaction at an undervalue (including making a gift) within a certain period before the start of a formal insolvency or gives a preference to one of its creditors at a time when it is insolvent, then the most likely outcome is an action under s.238 or 239 of the Insolvency Act 1986 rather than an action by the liquidator that relies on the creditor duty. Those sections, and s.423 of the Insolvency Act 1986 (which does not have an insolvency requirement, nor a fixed time before the formal insolvency), allow the court to make orders unravelling the relevant transfer, whereas the creditor duty is an argument primarily to be deployed against the directors, seeking compensation for breach of fiduciary duty (as in *Sequana*).

However the creditor duty might become relevant in the pensions context given the common overlap between trustee and employer, in particular by shared directors on the boards of both. In those circumstances it might be possible to argue that the trustee who received property from the employer at a time that the creditor duty was engaged but not complied with is liable in knowing receipt, if its receipt was with knowledge of the (employer) directors' breach of fiduciary duty.

The other scenario to consider is that of the trustees wishing to challenge a transaction entered into by directors of an employer or guarantor at a time that the creditor duty is engaged. The trustees (as creditors) have no direct claim against the directors for breach of the creditor duty, as the duty is owed to the company alone. A shareholder can in certain circumstances bring a claim in respect of the company's cause of action (a "derivative claim", under s.260 of the Companies Act 2006), but this is not a route open to creditors.

However trustees and their advisers should recall that in *Sequana* the claim that succeeded was a claim under s.423 of the Insolvency Act 1986 to challenge the dividend as a transaction defrauding creditors. Such a claim can be advanced by any "victim" of the transaction, most obviously the company's creditors, albeit with the leave of the court once an insolvency process has commenced. It requires proof that the transaction was entered into at an undervalue and for a purpose of prejudicing the interests of at least one present or future creditor (*JSC BTA Bank v Ablyazov* [2018] EWCA Civ 1176 at [13]). Although such a fact pattern might also fit the tests for the Pensions Regulator issuing a contribution notice under section 38 of the Pensions Act 2004, there is scope here for independent action by the trustees.

Tom Robinson is a barrister at Wilberforce Chambers specialising in pensions and insolvency law.

Published May 2023

This article was published on **www.pensionsbarrister.com**. Views expressed above are those of the author and are not necessarily those of Pensions Barrister. The article is provided for general information only and is made available subject to the Terms and Conditions found on **www.pensionsbarrrister.com** (which contain amongst other things a disclaimer and further limitations on liability). Nothing in the article constitutes legal or financial advice nor may it be relied on as such advice.