BusinessPlus+ Newsletter

Issue – March 2023

Business Essential Briefs: The Duty of Directors to Business Creditors

A recent legal case in the UK ***(BTI 2014 LLC v Sequana SA and others [2022])***, that is pertinent to Australian business, highlighted the need for all business directors to always consider their ability to pay their suppliers on time, whilst conducting the business and when paying dividends/distributions to their shareholders/beneficiaries or unitholders.

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 business, may be able to pierce the corporate veil and directly sue directors for their loss. 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*** a dividend was paid. 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 (i.e., 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.
- In the Australian context, it must be noted that under s 95A of the Corporations Act 2001, ***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 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 their mind to the interest of creditors — even when the director does not suspect insolvency.
- **Directors should document the steps taken to evaluate the creditors' interests** and how their decision took such interests into account. Directors when dealing with these issues, may consider engaging collaboratively with their accountants for advice on solvency and with their legal representatives, in creating appropriately worded documentation.
- **Check that any Directors & Officers insurance policy is up-to-date and fit-for-purpose**, as it may not provide coverage for breach of the creditor duty.

Disclaimer:

Business Plus is distributed monthly by CBSW Tax & Business Advisors to provide information of general interest to our clients. The content of this newsletter does not constitute specific advice. Readers are encouraged to consult their CBSW advisor for advice on any specific business matters.

Providing you professional direction

Our liability may be limited by a scheme approved under Professional Standards Legislation.