AN OTHERWISE LAWFUL DIVIDEND CAN BE A TRANSACTION DEFRAUDING CREDITORS

The case of *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 offers a warning to directors and companies. The English Court of Appeal concluded that the payment of a lawful dividend can be susceptible to challenge under section 423 of the Insolvency Act 1986 (transactions defrauding creditors) and that directors could have a duty to have regard to the interest of creditors in declaring the dividend.

Key issues

- The payment of an otherwise lawful dividend falls within the scope of section 423 of the Insolvency Act 1986 if it is motivated by the purpose of putting assets beyond the reach of creditors or otherwise prejudicing their interests
- There is no requirement to show that such purpose was the sole or dominant purpose, or that the directors acted fraudulently
- A claim under section 423 can be brought at any time by any victim who claims to have been prejudiced by the dividend payment - the company need not be insolvent
- A duty to have regard to the interest of creditors arises when the directors know or should know that the company is or is likely to become insolvent

Sequana focuses on the payment of two dividends, in December 2008 and May 2009 totalling approximately EUR580m, by a company to its parent company and sole shareholder, Sequana. The dividends were paid at a time when the company had ceased to trade and had one material contingent liability, the size of which was uncertain. In this case, the dividends were paid in unusual circumstances.

The directors' decision to authorise the dividends was called into question on the basis that, among other things, they acted with the intention of defrauding creditors under section 423 of the Insolvency Act 1986.

Section 423 of the Act has two principal requirements: (1) that there is a transaction at an undervalue (i.e. in the present case, for no consideration), which is (2) motivated by the purpose of placing assets beyond the reach of creditors, or otherwise prejudicing their interests. The claim does not need to be brought by an insolvency officer-holder (indeed the offending company need not be insolvent) and can be brought at any time by any actual or potential creditor who claims to have been prejudiced. Despite the name of the claim, there is no requirement to show that the directors acted fraudulently.

At first instance:

1. Sequana argued that a dividend paid by a company to its shareholder was incapable of being characterised as a transaction for no consideration or at an undervalue. However, the Court rejected this submission, holding that the terms of section 423 were "deliberately wide".
2. Sequana argued that the directors did not have the section 423 purpose (the 'statutory purpose') in relation to either dividend. While the Court was prepared to accept that submission as to the December 2008 dividend, it found that the May 2009 dividend was undertaken with the intention of putting assets beyond the reach of the company's main creditor. When making this finding, the Court confirmed that there is no need to show that the directors "acted in bad faith in the sense of having engaged in sharp practice or recklessness".

3. Sequana was liable under section 423 as a constructive trustee.

APPEAL

The Court of Appeal upheld that decision. In particular:

1. The payment of an otherwise lawful dividend falls within the scope of section 423 – there is no policy reason to exclude it. A dividend is no different from any other lawful transaction which is entered into for the purpose of putting assets beyond the reach of creditors or otherwise prejudicing their interests.
2. The statutory purpose under section 423 is essentially a question of fact – what was the director aiming to achieve when he/she approved the dividend? Section 423 does not require the specific purpose to be the sole or dominant purpose – it is sufficient if it can properly be described as a purpose and not merely as a consequence, rather than something which was positively intended.

The Court of Appeal also helpfully clarified the common law rules on when directors have a duty to have regard to the interest of creditors: "*the duty arises <u>when the directors know or should know that the company is or is likely to become insolvent</u>... In this context, “likely” means probable*". In the present case, the duty was held not to be engaged.

The Court of Appeal has refused permission to appeal but the appellants can apply for permission from the Supreme Court.

PRACTICAL LESSONS

The decision is important for all boards of directors and companies.

In order to guard against claims for breach of duty or under section 423 of the Act:

- Directors should ensure adequate and effective internal controls are implemented and maintained regarding the regular reporting of financial information to them.
- If there may be concerns about the company's long-term financial health, before making a dividend distribution, the directors should carefully consider its purpose, the interests of creditors and whether to obtain specialist insolvency advice.
- Particular care is needed where directors are aware of a contingent creditor but unclear as to the size of the claim.
- Directors should consider obtaining regular advice on how they can discharge their duties to the company.

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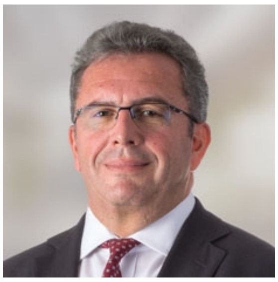

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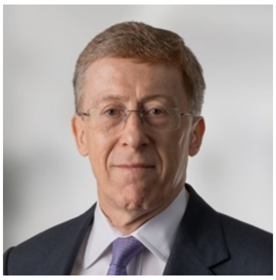

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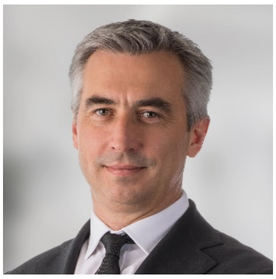

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