In The Zone? When Directors of Portfolio Companies Have to Take Creditor Interests into Account

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Representatives of asset managers often take up positions on the boards of portfolio companies. We have written posts before on some of the litigation and regulatory risks that can arise, both for the asset managers and the individuals including: Portfolio Company Risk: Plaintiffs Set Sights on Sponsors and Board Directors, The Trend of Increasing Disclosure Obligations for Private Funds Continues in 2022, SEC Proposes Advisers Act Reforms Focusing on Private Fund Investor Protections.

Diversified portfolios often mean companies in several different jurisdictions (and this can be the case even within one corporate group), so that differences in the standard of directors' duties across those jurisdictions can be highly relevant. With all the signs of a global economic downturn, these duties may soon be tested.

The English Supreme Court recently considered the extent to which, and when, directors of an English incorporated company must take account of the interests of creditors – the so-called "*creditors' duty*". This duty applies even before a company enters insolvency, from when it is in "the zone of insolvency".

As explained below, this decision means that English law is now confirmed as taking a markedly different approach to Delaware and most other US jurisdictions, where no fiduciary duty to creditors arises at all until the actual event of insolvency.

Directors' duties to creditors – English position

Under English law, codified in the 2006 Companies Act (CA 2006), directors must act in the best interests of the company, meaning the interests of the shareholders as a whole. This duty flips once a company enters an insolvency process or such process is inevitable and at that point the interest of its creditors (as a whole) become paramount. The question arose as to the position when a company may be approaching insolvency.

In *BTI v. Sequana*, a board of directors paid out a dividend. At the time, the company was solvent and all applicable legal tests on the maintenance of capital had been applied. The company had a number of long-term contingent liabilities related to environmental liabilities. The company entered an insolvent administration nearly a decade later. One of its creditors asserted that the directors should have considered its interests when paying out the dividend because there was a real risk of a future insolvency, even then.

The Supreme Court confirmed the existence of a "*creditor's duty*" at common law, which qualifies directors' statutory duties and requires directors to have proper regard to the interests of current and prospective creditors when exercising their powers.

The Court clarified when this duty is engaged. The Judges disagreed that it was triggered by a "real" risk of future insolvency, as submitted by the claimant, but equally considered that the duty was engaged before insolvency was inevitable. The trigger is when directors know – or ought to know – that the company is insolvent, is bordering on insolvency or an insolvency process is probable, or that the transaction in contemplation will put the company in such a situation. At that point, creditors' interests must be a factor in decision making, and the weight that must be given to those interests compared to those of shareholders increases as the company's financial situation worsens.

The Supreme Court left open the question of the exact standard of knowledge of directors, whether this standard is objective or subjective. Company directors, however, have a wide duty of care to keep themselves informed of company affairs. The Court also gave no guidance on what to do where different creditors' interests are unaligned.

Directors' duties to creditors – U.S. position

When faced with a similar question, Delaware courts have consistently rejected the contention that directors hold fiduciary duties to creditors at any point before the company is actually insolvent. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the Delaware Supreme Court held that creditors cannot bring a direct claim against a company's directors when the company is in the "*zone of insolvency*". Directors of a corporation that is approaching insolvency must have the same focus as directors of a corporation that is comfortably solvent – namely, that they must exercise their business judgment in the best interests of the corporation for the benefit of its shareholders. As the Delaware Chancery Court later put it in *Quadrant Structured Products Company, Ltd. v. Vertin*, decided eight years after *Gheewalla*, "*the only transition point*" at which the subject of a director's fiduciary duty can shift "*is insolvency itself*."

While most U.S. jurisdictions appear to follow Delaware's lead, at least one has suggested that directors' duties to creditors can arise when a company is in the "*zone of insolvency*" but not yet insolvent. In *Carrieri v. Jobs.com*, the Fifth Circuit wrote that once the debtor's directors "*became aware*" that the debtor was "*within the zone of insolvency*," they may open themselves up to breach of fiduciary duty claims. This would be in line with the position of the UK Supreme Court in "Sequana." However, because this statement was *in dicta* and contradicted an earlier Fifth Circuit opinion in which the Court stated directors owe no fiduciary duties to creditors so long as the company "continues to be a going concern," it has not been seen as having any precedential value.

Implications

Regardless of jurisdiction, practical tips for directors include:

- Being aware that a lawful dividend could still amount to a breach of a duty to creditors.
- Documenting relevant decisions, including the facts taken into account (to include where relevant the company's financial position and that of its creditors).
- Being alert to possible material breaches or termination events under key commercial contracts as well as future contingent liabilities that could significantly impact the company's financial position.

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Related Professionals

- **Dorothy Murray**

  Partner

- **Julia D. Alonzo**

  Litigation Legal Director and Head of Women’s Initiatives