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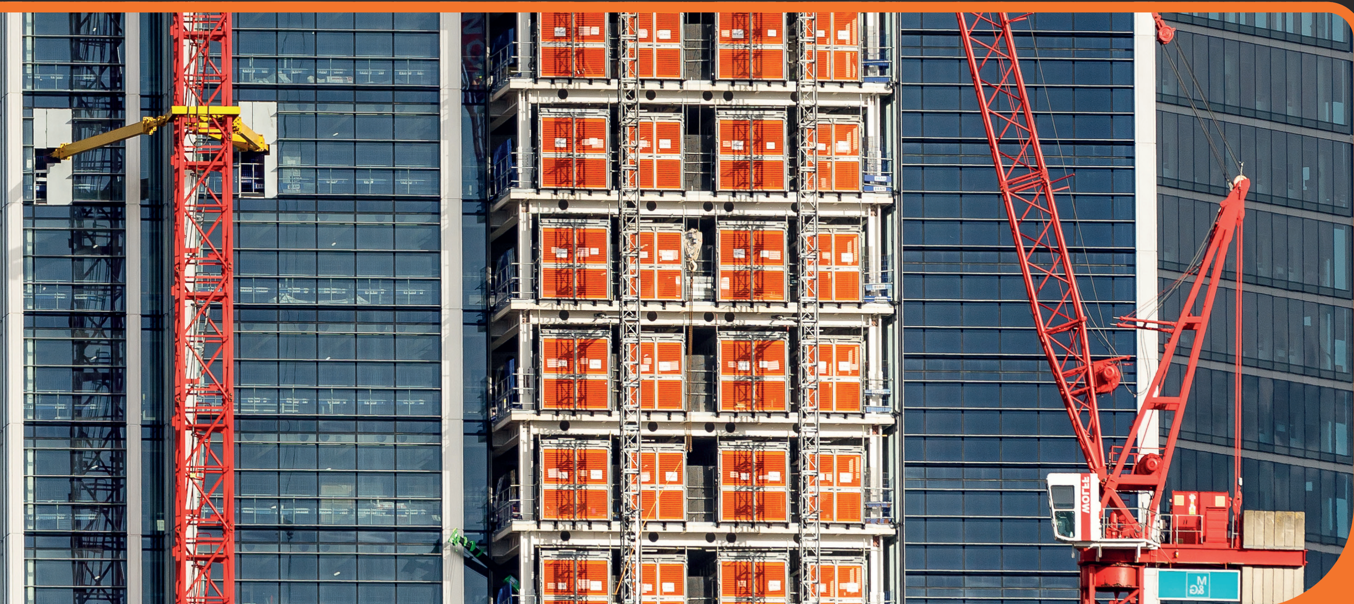

Practical cross-border insights into restructuring & insolvency law

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To File or Not to File? That is the Question!

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Introduction

Hamlet needed to consider whether it was nobler in the mind to suffer the slings and arrows of outrageous fortune. Many directors of troubled companies will feel in a similar position. However, unlike Hamlet's countryman Laertes, who was advised "neither a borrower nor a lender be", directors also have the interests of creditors to consider.

A set of rules to protect the interests of creditors will lie at the heart of any well-functioning insolvency regime. This will include not only rules to protect creditors during a formal insolvency process, but also rules to protect creditors prior to a company's directors filing a request to open such a process. There have been key developments in this area in the past year in both the European Union and the United Kingdom.

At the end of last year, the European Commission published its proposal for a new insolvency directive, widely referred to as "Insolvency III". This proposal sought to harmonise certain aspects of EU insolvency law. Among other things, in order to protect creditors, directors of companies throughout the EU would be required to file a request to the court to open proceedings no later than three months after they became aware (or could reasonably be expected to have become aware) that their company was insolvent and would be personally liable for losses incurred by creditors should they fail to comply.

Meanwhile, in October of last year, the UK's Supreme Court delivered its judgment in the case of *BTI 2014 LLC v Sequana SA & Others [2022] UKSC 25*, which one of the judges involved hailed as a "momentous" decision for the purposes of company law. The judgment provides much clearer guidance than had previously existed as to when, and to what extent, directors of a UK company must have regard to the interests of creditors when discharging their duties to the company.

In this chapter, we look at the contrasting approaches taken in Germany and in the United Kingdom towards protecting the interests of creditors prior to a formal insolvency process and offer some thoughts on the differences between the two.

When Must German Directors File?

Under Insolvency III, Member States would still be allowed considerable latitude both as to how to interpret the concept of "insolvent" and as to the nature of the proceedings for which the director must file. Nevertheless, some Member States would still need to make changes to their existing laws to comply with these requirements. In contrast, Germany's laws not only already comply with these requirements, but arguably gold-plate them.

In Germany, illiquidity and over-indebtedness are both grounds for the directors of a corporate debtor to file an insolvency petition. With shareholder consent, imminent illiquidity is already a ground to file voluntarily for insolvency.

A debtor is illiquid if its present, liquid funds are not sufficient to meet its debts when due, and if any additional liquid funds which it would expect to receive within the next three weeks are still insufficient to meet at least 90% of its due debts and its debts which are expected to fall due within the next three weeks. This is therefore a cash-flow test. Illiquidity is presumed if the debtor has stopped its payments.

A debtor is considered to face imminent illiquidity if it is more likely than not to become illiquid within the foreseeable future. What "foreseeable future" entails will depend on the specifics of the debtor's business operation. However, it would usually be a period of 24 months.

Over-indebtedness exists if the debtor's assets no longer cover its existing obligations. This is a balance sheet test, albeit the test applies liquidation values. Nevertheless, a company will not be "over-indebted" if it is more likely than not that the business can continue because it has sufficient liquidity to meet its financial obligations for a specified period of time. This concept is known as the "going-concern prognosis". The period in question is ordinarily set at 12 months. It has been reduced to four months until the end of 2023, but the effect of this is that as from September 2023, a 12-month period will apply once again. A positive going-concern prognosis therefore eliminates the obligation to file for insolvency despite a balance sheet over-indebtedness. However easy this may sound in theory, a going-concern prognosis is in practice anything but easy to determine.

A managing director is required to file for insolvency without undue delay, and at the latest three weeks after the company has become illiquid. They are also ordinarily required to file at latest six weeks after the company has become over-indebted, although this period has been extended to eight weeks until the end of 2023. There is no obligation to file for insolvency just on the basis of imminent illiquidity.

If a managing director intentionally or negligently fails their obligation to file for insolvency without undue delay, they commit a criminal offence. The failure to file also exposes them to civil liability. The above-mentioned time periods, so-called "cure periods", may be utilised only if and as long as there is substantial cause to believe that the grounds for insolvency may be entirely overcome within this timeframe. During those cure-periods, as of the date when the company is either illiquid or over-indebted, a managing director may only initiate payments that are required to maintain the business operations or to prepare insolvency filing and otherwise faces civil liability for any payments that can be regarded as causing damage to the company's creditors.

After an insolvency application is filed, the insolvency court will often appoint an insolvency expert as a preliminary

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administrator with the duty to preserve the future insolvency estate pending a subsequent hearing to determine whether to open insolvency proceedings. If the proceedings are structured as debtor-in-possession proceedings aiming to restructure the debtor by way of an insolvency plan, a preliminary custodian will be appointed to supervise the management actions instead (although in practice they are chosen from the same pool of persons who regularly act as insolvency administrators).

When Must UK Directors File?

In contrast, in the UK, no mandatory filing requirement is triggered as a result of a company becoming cash-flow or balance sheet insolvent. As the UK is no longer an EU Member State, it has no obligation to amend its existing laws in order to comply with Insolvency III.

The so-called "wrongful trading" provisions in the UK's legislation do provide an incentive for directors to file once it is clear that the company can no longer survive as a going concern, at least in the absence of a filing. If a company enters insolvent administration or liquidation, and it transpires that at some earlier point in time a director knew, or ought to have concluded, that there was no reasonable prospect of avoiding entry into such a process, but failed to take every step with a view to minimising the potential loss to the company's creditors as that director ought to have taken in those circumstances, that director may be made personally liable for losses to creditors. The steps that the director is expected to take to minimise losses to creditors are most likely then to be those needed to prepare for formal insolvency proceedings and to protect the interests of creditors as an overall body while they complete those preparations.

However, this is a late trigger. There may well still be a lengthy period of time between the date on the which a company first becomes insolvent and the date on which it eventually fails the "no reasonable prospect" test.

In addition, even where a wrongful trading action is successful, the total amount which creditors are able to recover will be linked to the amount by which the overall position of the creditors has worsened between the date the company fails the "no reasonable prospect" test and the date on which the insolvency proceedings are opened. If the insolvency officeholder is unable to demonstrate that the overall position has worsened during that time, no creditor recovers anything.

For these reasons, wrongful trading is often viewed as an inadequate remedy. Insolvency officeholders, and indeed individual creditors, are therefore keen to consider alternative remedies against directors based on more general breach of duty claims. Similarly, it may be the threat of such claims which provide the greatest onus for the directors of an English company to look after the interests of its creditors alongside those of its other stakeholders.

What Happened in the Sequana Case?

The Sequana case concerned a company called AWA. In May 2009, AWA's directors caused it to distribute a dividend of €135 million to its parent, Sequana. At that time, Sequana owed a debt in a similar amount to AWA. The dividend therefore extinguished almost the whole of that debt by way of set off.

At that time AWA had a contingent liability for some potentially significant environmental clean-up costs. The directors had carried out a substantial amount of work to attempt to reach a best estimate of this liability. They had concluded that the liability should be adequately covered by an insurance policy held by AWA and that there was no need to make provision in its accounts. AWA's auditors concurred.

When it paid the dividend, AWA was therefore fully solvent on both a balance sheet and a cash flow basis. The dividend also complied fully with the provisions of English company law which require a company to have sufficient "distributable profits" to cover the amount of any dividend it pays, as well as with English common law principles relating to so-called "maintenance of capital". However, there remained some uncertainty both as to the total amount of the liabilities and the value of the policy. As a result, there remained a real risk, albeit not a probability, that AWA might become insolvent at some date in the longer-term future.

In the event, the clean-up costs exceeded the level predicted and AWA entered administration almost 10 years later. It assigned its claims to BTI 2014 LLC (BTI).

BTI brought claims against AWA's directors to recover the dividend. It alleged that, by paying the dividend, AWA's directors had breached their duty to have regard to the interests of AWA's creditors in circumstances where there was a risk of AWA becoming insolvent. It argued the directors should not have distributed the dividend while AWA still had potentially significant long-term liabilities.

When do UK Directors Have a Duty to Consider Creditors' Interests?

So, what general obligations do the directors of a UK company have to take into account in the interests of creditors in the period before formal insolvency becomes inevitable?

Under UK company law, the directors of a company owe a duty to the company to promote the success of the company for the benefit of its members (who will usually be its shareholders) as a whole. Nevertheless, this duty to promote the company's success is expressed to be subject to any rule of law that requires the directors, in certain circumstances, to consider or act in the interests of the company's creditors.

At the time of the Sequana case, it was already understood that when a company is cash-flow or balance-sheet insolvent, the directors are under a duty to consider the interests of the company's creditors rather than its members. However, the full scope of this duty, including whether it arises in respect of a company which is not yet insolvent, was less clear.

What did the UK Supreme Court Say?

The UK Supreme Court ruled in favour of the directors. The judges involved handed down four judgments in total, and there are subtle differences between them. However, in summary the court came to the following conclusions:

- First, a common law duty on directors to consider the interests of creditors as a general body will arise in certain circumstances. This is a modification of the directors' general duty to promote the success of the company, but the directors still owe that duty to the company, and so creditors cannot ordinarily bring direct action against directors who fail to take their interests into account. Only the company itself (probably through an insolvency officeholder) or an assignee of the company's claims can bring that action.
- Second, although the applicable English company legislation does not codify this common law duty, it does acknowledge and preserve it. The court confirmed that the legislation specifically recognises that the duty to act in the interests of the members can be subordinated when the duty to consider creditors arises.
- Third, the duty arises when a company is insolvent or where insolvency is imminent. The court identified three such situations: if the company is cash-flow or balance

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sheet insolvent; if it is bordering on insolvency; and if a transaction would place the company into one of those two situations. The duty does not arise merely if insolvency is a real but improbable risk or if future insolvency is simply likely.

- Fourth, the duty does not mean that members' interests can be ignored. Save where administration or liquidation are unavoidable, creditors' and members' interests need to be balanced. The more precarious the financial state of the company, the more the creditors' interests are likely to dominate and *vice versa*.
- Fifth, the directors themselves do not need to realise that the company is insolvent or that insolvency is imminent. The duty may apply if a "reasonably diligent and competent director" would have released that this was the case. The directors of a company are required to keep themselves aware of the company's financial position. The fact that they have failed to do so in practice provides no defence.
- Sixth, the members cannot ratify a breach of the duty. Ordinarily, the members can pre-authorise an action which would otherwise be breach by the directors of their duties or can ratify a breach which has already occurred. This is not possible once the duty to consider creditors arises.

The court also confirmed that, when authorising a dividend, directors will not avoid a breach of duty merely because the dividend is paid lawfully under the separate company legislation applicable to dividends.

The court made it clear that the statutory wrongful trading provisions described above complement, but remain separate from, this common law duty to creditors. They were nevertheless a factor in the court's conclusion that the interests of creditors and members need to be balanced until formal insolvency becomes unavoidable. One judge observed that if the duty to creditors became paramount as soon as cash-flow or balance-sheet insolvency became imminent, there would have been no need for the wrongful trading legislation.

Concluding Thoughts

Germany is one of only a few jurisdictions in Europe that require directors to file because a company is over-indebted. In most jurisdictions where insolvency already triggers a mandatory filing requirement, directors are required to file only if the company fails a liquidity test. This is unlikely to change as a result of Insolvency III, since a liquidity test alone will likely prove sufficient to satisfy its requirements. Many believe that an over-indebtedness test is unnecessarily burdensome on directors and argue that the reduction in the going concern prognosis period to four months was a tacit acceptance of this.

However, insolvency experts who take on the role of preliminary administrator tend to support the present position. They argue that it ensures an earlier intervention by an appropriately qualified professional, which is likely to preserve value for creditors, and possibly also members.

The UK has traditionally acknowledged the need to balance creditors' interests with the need to allow the directors flexibility to take the risks inherent in business. This has not changed. Indeed, the Sequana judgment confirms that the duty to consider creditors' interests is not invoked as early as had previously been understood, and would not generally exclude consideration of the members' interests.

Supporters of this argue that directors of a healthy, solvent business should always be at liberty to concentrate squarely on the interest of its members. At the other end of the scale, where the company's entry into formal insolvency is inevitable, the interests of the company's creditors become paramount, and directors are likely to be advised to file. In between, directors will need to balance the interests of the company's members and its creditors where those interests conflict, reviewing its financial status regularly to understand the emphasis to give to each of them.

However, others in the UK believe that the UK's approach allows directors of a troubled company for trade for too long without putting that company into the hands of an insolvency professional. Members may still try to pressurise directors by contending that if they file too early they will be in breach of their duty to promote the success of the company for the benefit of its members. An insolvency professional might be better skilled at preserving value for members, and even if there was no further prospect of this, might seek to sell its business as a going concern in order to maximise value for creditors.

At present an over-indebted UK company may well continue to survive for some time and to continue to pay its creditors but fail to make further capital investments into its business. We are well aware of companies becoming "zombies" whose businesses slowly decline in value and realise little when eventually sold. Critics of the UK's approach have also pointed out that it gives too much power to secured creditors, who may well pressurise directors to time an eventual formal insolvency to suit their interests alone. None of this may be in the interests of the company's other creditors, or indeed of other stakeholders such as employees.

We may never resolve between us whether the German or the UK approach is the better overall. We might each look at the other and take the view that "this be madness, yet there is method in it". Others may argue that an approach which requires a mandatory filing in the case of illiquidity, but not over-indebtedness, is better still. Whatever the case, we can see this being a fertile ground for debate for years to come.

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Simon was the author of the *Insolvency and Restructuring Manual*, which was first published shortly after the 2008 financial crisis. A fourth edition of that work was recently published by Bloomsbury Professional Ltd. Simon is also the co-author of Bloomsbury's *Guide to the Corporate Insolvency and Governance Act 2020*, the latest major piece of UK insolvency legislation.

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