How Directors Can Manage the UK Supreme Court's 'Balancing Exercise' in Difficult Times

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Key Points

- Under a recent U.K. Supreme Court decision, directors may be required to consider the interests of creditors as well as those of shareholders if their company is nearing insolvency.
- To fulfill their fiduciary duties at a company in financial distress, directors should rigorously assess risks to the business, and they may need to hold more frequent board meetings.
- Thorough documentation of the board's efforts is essential in case the company's position deteriorates and the board's actions are later questioned.
- Above all, directors must be scrupulous about avoiding conflicts of interest and adhere to decision-making formalities.

Economic downturns can put both companies and their boards to the test. An important judgment from the U.K. Supreme Court in October 2022, the *Sequana* case,[1] clarifies the obligations of directors of a company facing the possibility of insolvent liquidation or administration, a condition sometimes referred to as the "zone of insolvency."

The Supreme Court confirmed that, in those circumstances, directors must assess the interests of both the companies' shareholders and creditors generally and, to the extent those interests conflict, the directors must undertake a "balancing exercise." In some circumstances, the directors may even be required to treat shareholders' interests as subordinate to those of the creditors. Much will depend on whether a course of action proposed by the directors was likely to "lead the company away from threatened insolvency, or back out of actual insolvency."

(In contrast, under Delaware law, which governs most publicly traded U.S. companies, directors owe fiduciary duties solely to the corporation and its stockholders, and that duty is never modified to include creditors' interests, even as the corporation approaches the zone of insolvency and after it becomes insolvent. Once a Delaware corporation is insolvent, however, its creditors, as the residual stakeholders of the corporation, do have standing to bring derivative claims against directors on behalf of the corporation to enforce the fiduciary duties the directors owe to the corporation.)

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Under English law, as under Delaware corporate law, courts do not second-guess disinterested directors' decisions made in good faith or demand that every commercial decision such directors make results in a positive outcome. Unless it is shown that the directors lacked good faith, were self-interested or failed to follow a proper process, courts will nearly always defer to directors' business judgment.

Best Practices

There are concrete steps directors can take to navigate an uncertain environment, achieve the balance the *Sequana* judgment spoke of and protect themselves against criticism in the event of a later failure.

1 *BTI 2014 LLC v Sequana SA [2022] UKSC 25*. Skadden represented Sequana SA and the former directors of one of its subsidiaries, AWA, in this case.

Assess risks. Directors should undertake regular reviews of the risks the company faces (including with assistance from professional advisers, as discussed below). These reviews should encompass legal and regulatory issues as well as commercial risks. Questions to ask include:

- Are there parts of the business that are likely to encounter increased regulation, and what impact could that have?
- Is the business overly reliant on a specific customer or supplier? If so, what are the contingency plans if that commercial counterparty is taken over or shuts down?
- Is the company overly reliant on a particular group of employees? What are the plans to retain them, or the contingency plans if they leave?
- Is the business dependent on a particular product? If so, is it coming to the end of its product life, and what are the plans to replace it?
- What happens if the territory in which a business partner is based becomes a pariah state?

When a company's operations encounter challenges, an additional set of questions focused on the financials should be raised:

- What is the company's liquidity position?
- If cash reserves were to be depleted (or its working capital requirements increased, for example, due to changes in customer or supplier payment terms or as a seasonal variation in the cashflows), what credit facilities are available to the company to allow it to continue to trade?
- Are those facilities subject to imminent termination or suspension? If so, does it make sense to draw down existing facilities now, while still available?
- What are the company's short-term and long-term liabilities, and what provisions are in place for the company to meet them as they fall due?

Directors are not expected to make risks disappear, but they are expected to assess the risks that exist, and, to the extent possible, make plans to address them.

Hold regular meetings. Typically, board meetings are held six to 10 times per year. At these sessions, management is expected to present updates on operations and take questions on financial performance. It is important for meetings to be held regularly, with detailed board packs so that directors have access to the best available information. If meetings are only quarterly, or if they are not well attended or board packs are not sufficiently detailed, directors put themselves at risk of being criticized for not closely monitoring the company's financial health.

When a company enters financial stress, it may be appropriate for the board to convene more often, and directors should be prepared to commit more time. Weekly, or even daily, board meetings may be necessary to allow directors to receive real-time updates and to give management appropriate guidance. Expectations are different for executive and nonexecutive directors but, when the company faces difficulties, nonexecutives are expected to devote more time to their role and to challenge the executive team more closely.

Keep diligent records. When a company enters a formal insolvency process, an investigation of past decisions will start with a review of its books and records. Although additional paperwork may be unwelcome at a time of financial distress, to protect directors, it is essential that detailed papers are formally presented at board meetings and that fulsome board minutes of discussions are taken (including, within reason, the range of differing views around the board table). It is important that the minutes accurately reflect the actual position of the company and are not contradicted by internal correspondence and documentation, which is also likely to be reviewed.

A full record should demonstrate that directors sought the best available information, made an assessment of the options available and chose a particular option with good reason. Where such a record exists, it will be much harder to assert that directors neglected their duties or acted in bad faith.

Focus on probity. Matters such as conflicts of interest and formal decision-making processes gain heightened importance after a company enters into an insolvency procedure. Any issue that can be seen to have tainted the integrity of decisions puts directors at risk. Directors should therefore pursue clarification from the company secretary or the company's lawyers that conflicts have been identified and addressed, and that corporate approvals have been obtained, as required by corporate law and the company's constitutional documents.

Directors should also feel free to ask that a review be undertaken to confirm that the company has not exposed itself to the risk of premature termination of key commercial contracts by not fully complying with ongoing terms.

Directors would also be well advised to ask for confirmation that appropriate directors' and officers' (D&O) insurance policies are in place.

Seek advice. Directors are not expected to have all the answers. Professional advisers will often have experience dealing with the kinds of difficulties a company faces. Directors should therefore insist on direct access to the company's financial, business and legal consultants. Good ones can also bring perspective and ideas, which can provide the directors with a route through to the survival of the company. And to achieve those goals, it may be appropriate to augment or replace existing advisers and bring in fresh expertise. Directors should feel empowered to require such changes.