The Codification of the Directors Duty to Consider the Interests of Creditors in Irish Company Law

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Michael James Boland is a PhD Researcher at the School of Law, University College Cork. In this blog, Michael considers the codification of the directors' duty to consider the interests of creditors. Although it is well-established as one of the fiduciary duties of directors, the duty to have regard to the interests of creditors when the company is insolvent or is approaching insolvency was only placed on a statutory footing in 2022 and is now provided for in Section 224A of the Companies Act 2014. This blog post will consider the background to the new statutory provision as well as its contents and its implications for practice. It will also consider briefly whether guidance on the operation of the newly codified duty can be drawn from recent jurisprudence of the UK Supreme Court concerning a similar directors' duty in English law.

I. Background

The duty owed by company directors to consider the interests of creditors when the company is insolvent or is approaching insolvency that was established by the Supreme Court in the case of *Re Frederick Inns LTD*[1] has been codified in the Companies Act 2014.

The case of *Frederick Inns* concerned four companies "pending imminent liquidation"[2] that contributed to the debts of six other companies in the group. In holding that the payments were "not lawfully and effectively done"[3] as they were made in breach of the duty that the directors of the four companies owed to the creditors of those companies, Blayney J on behalf of the Court quoted with approval the following statement from Street CJ in *Kinsela v. Russell Kinsela Property LTD*[4]:

> In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. *But where a company is insolvent the interests of the creditors intrude*. They become prospectively entitled, through the

> mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. *It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration*.[5]

More recently in *Re Swanpool LTD; McLaughlin v. Lannen*[6], Clarke J (as he was) made clear that the extent to which a director complied with their obligations from *Frederick Inns* would be important in determining their honesty and responsibility for the purposes of the restriction process provided for in Part 14, Chapter 3 of the Companies Act.[7] Clarke J explained that the duty from *Frederick Inns* obliges directors of insolvent or nearly insolvent companies "to preserve the assets [of the company] so as to enable them to be applied *pro tanto* in discharge of the company's liabilities".[8] He added that "[t]here can be little doubt ... that amongst the important duties of directors is to ensure that, when it becomes clear that a company is insolvent, the assets are preserved and dealt with in the way in which the [Companies Act] require[s]".[9] Clarke J therefore restricted the respondent directors from being involved 'directly or indirectly' in the formation or promotion of a company for five years for having failed to discharge the company's liabilities in accordance with insolvency law in circumstances where the company was approaching insolvency.

The Company Law Review Group (CLRG) recommended codifying this obligation in its first report in 2001[10] and also in a more recent 2017 report on employees and unsecured creditors.[11] It did so again in 2020 in a report on company law issues arising from the pandemic[12] and most recently in a 2021 report of the insolvency sub-committee on corporate liquidation and restructuring.[13]

The requirement to consider creditors' interests when the company is approaching insolvency is also a provision of the Preventive Restructuring Directive at Article 19.[14]

II. The Codified Duty

The European Union (Preventive Restructuring) Regulations 2022[15] transposed the Directive into Irish law and inserted the new Section 224A into the Companies Act 2014. It also inserted a new provision to Section 228 of the Act - Section 228(1)(h)(i) – which provides that

> A company director shall ... in addition to the duties under section 224A (directors to have regard to certain matters where company [sic] is, or is likely to be, unable to pay its debts), have regard to the interests of its creditors where the directors become aware of the company's insolvency.

Section 224A which is "supplemented"[16] by Section 228(1)(h)(i) codifies the duty from *Frederick Inns* and gives effect to Article 19 of the Directive as follows:

> A director of a company who believes, or has reasonable cause to believe, that the company is, or is likely to be, unable to pay its debts, within the meaning of section 509(3), shall have regard to:
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> a) the interests of the creditors,
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> b) the need to take steps to avoid insolvency, and
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> c) the need to avoid deliberate or grossly negligent conduct that threatens the viability of the business of the company.

The duty at Section 224A will therefore arise when directors believe or have reasonable cause to believe that the company is or is likely to be unable to pay its debts within the meaning of Section 509(3).

Section 509(3) provides that a company will be unable to pay its debts for the purposes of Section 224A if it cannot do so as they fall due, if the value of its assets is less than the total amount of its liabilities including contingent and prospective liabilities,[17] or if 21-days have passed after a demand for repayment has been made of the company and the company has failed to discharge its debt having regard to Section 570 of the Act.

III. The Position in England

The obligation on directors to have regard to the interests of creditors in UK company law was recently considered by the UK Supreme Court in *BTI 2014 LLC v. Sequana SA & Ors*.[18] Although the UK duty[19] is not identical to the Irish duty,[20] guidance from the *Sequana* case may still be instructive in an Irish context. The Court found that the duty arises when the company is insolvent or notably when there is a *high* likelihood bordering on *imminent* likelihood of insolvency. Lord Briggs, who gave the majority judgment, explained that the duty will be engaged in cases of

> ... either imminent insolvency (i.e. an insolvency which directors know or ought to know is just round the corner and going to happen) or [where there is] the probability of an insolvent liquidation (or administration) about which the directors know or ought to know ... It will not be in every, or even most cases when directors know or ought to know of a probability of an insolvent liquidation, earlier than when the company is already insolvent. But that additional probability-based trigger may be needed in cases where the probabilities

about what lies at the end of the tunnel are there for directors to see even before the tunnel of insolvency is entered.[21]

IV. The Duty is owed to the company not to its creditors

It is important to note that Section 224A operates in the same way as any other directors' duty insofar as it is "owed to the company (and the company alone)...".[22] That is to say, the duty in Section 224A is owed to the company not to creditors just like the duty to have regard to the interests of employees in Section 224 is owed to the company not to employees.

Referring to Section 224, Courtney explains that "[t]he net effect of S. 224 may be said to be: directors are obliged to have regard to the interests of employees but the recipients of the statutory favour may not themselves enforce the directors' duty".[23] The same can be said of Section 224A.

That directors owe their duties to the company rather than to shareholders or any particular stakeholder like creditors or employees is a long-standing maxim of company law that was expressed as far back as 1902 in *Percival v. Wright*[24] - decided just five years after the modern company was born in *Salomon's*[25] case. It finds expression today in Sections 227(1),[26] 224(2)[27] and most recently in Section 224A(2) of the Act. It was recently affirmed by the High Court in *Keating v. Shannon Foynes Port Company*[28] in which Sanfey J found that the directors of the defendant company were in breach of their duty to act in the interests of the company "by following slavishly the wishes of the shareholder[s]".[29] Sanfey J said that in the circumstances of the case the directors were entitled to 'have regard' to the wishes of the shareholders but that "the primary fiduciary duty of the directors" in exercising their duties is to act in good faith in what the directors consider to be the interests of the company.[30]

V. Implications for Practice

From the point of view of company directors, the codification of the duty to consider creditor interests in Section 224A should not bring about any significant change as it has been one of their fiduciary duties for nearly 30 years. Section 224A should nonetheless help directors to properly and more effectively exercise their obligations under this duty. As stated, Section 224A provides that the duty will arise when directors 'believe, or have reasonable cause to believe, that the company is, or is likely to be, unable to pay its debts, *within the meaning of section 509(3)*' (emphasis added). It will be recalled that Section 509(3) sets out the circumstances in which a company will be deemed unable to pay its debts. Although it is a non-exhaustive list,[31] the circumstances listed in Section 509(3) nevertheless provide clear signposts for directors as regards when the duty to consider the

interests of creditors will be triggered. It follows that if, for example, the company's accounts show that its liabilities exceed the value of its assets, then this according to Section 509(3) would indicate that the company *is* unable to pay its debts at which point the duty to consider creditors' interests would arise. Likewise, if the company's records reveal a sharp decline in sales or an "unsustainable increase in expenses",[32] then these and similar events may indicate that the company *is likely to be* unable to pay its debts. The effect of this would be to trigger the duty to consider the interests of creditors.

For the purposes of Section 224A, the duty will therefore arise when directors *'believe'* that the company is unable to pay its debts or that there is a likelihood of this. This belief may be based on the contents of the company's books and records like in the example above. However, it will be recalled from earlier in this blog post that the Regulations inserting Section 224A into the Act also inserted Section 228(1)(h)(i) quoted above. Although it is described as being 'supplementary'[33] to Section 224A, Section 228(1)(h)(i) suggests that the duty to have regard to the interests of creditors will arise "where the directors become *aware* of the company's insolvency" (emphasis added). A *'belief'* which is all that Section 224A requires to trigger the duty is quite different to an *'awareness'* which is what is required under Section 228(1)(h)(i). Dictionary definitions of these terms would suggest that the most significant difference lies in the level of knowledge expected of a person having an awareness of something compared to that expected of someone holding a belief. In respect of the term 'belief', the Oxford English Dictionary provides a list of varied definitions depending on the context in which the word is used.[34] However, all these definitions agree that a 'belief' involves accepting and trusting information as the truth. There are likewise different contextualised definitions of the term 'aware' given by the Oxford English Dictionary.[35] The definition most relevant to Section 228(1)(h)(i) refers to having and understanding information. This suggests that greater or more concrete knowledge to that underpinning a person's belief would be expected for awareness. This would mean that in order to comply with their obligations under Section 228(1)(h)(i), directors would perhaps need conclusive evidence that the company is insolvent from, say, an independent accountant or auditor rather than a belief based on their own assessment of the company's books and records that the company is insolvent or approaching insolvency.

If, as it is described, Section 228(1)(h)(i) supplements/supports[36] Section 224A, then the distinction between these provisions should have little practical significance. Clarification would nonetheless be welcome on what it means to "become aware of the company's insolvency" in Section 228(1)(h)(i). Is a belief of insolvency enough or is conclusive evidence of the company's insolvency necessary? If the former is sufficient, then Sections 224A and 228(1)(h)(i) would operate in the same way and the issue would be settled. However, if conclusive evidence of insolvency is necessary, then there are arguably two instances in Irish law where the duty to consider creditors' interests will be triggered -

the first provided for in Section 224A and the second in Section 228(1)(h)(i).[37] From the perspective of directors who may be held to account for breach of this duty, clarification on how these provisions operate and their relationship to each other would be welcomed.

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[1] [1993] IESC 1, [1994] 1 ILRM 387 (Frederick Inns).

[2] ibid 397.

[3] ibid.

[4] [1986] 4 NSWLR 722.

[5] ibid 730 (emphasis added).

[6] [2005] IEHC 341, [2006] 2 ILRM 217 (Swanpool).

[7] ibid 223.

[8] ibid 221.

[9] ibid.

[10] Company Law Review Group, *Annual Report* (March 2001) 239-240 <https://clrg.org/publications/first-report-of-the-company-law-review-group-2001.pdf> accessed 5 January 2023.

[11] Company Law Review Group, *Report on the Protection of Employees and Unsecured Creditors* (June 2017) 33-39 <https://clrg.org/publications/clrg%20adhoc%20committee%20report.pdf> accessed 5 November 2019.

[12] Company Law Review Group, *Report on measures to address company law issues arising by reason of the COVID-19 pandemic* (June 2020) 19 <https://clrg.org/clrg/publications/the-report-of-the-company-law-review-group-on-measures-to-address-issues-arising-by-reason-of-the-covid-19-pandemic.pdf> accessed 17 May 2021.

[13] Company Law Review Group, *Report on the consequences of certain corporate liquidations and restructuring practices, including splitting of corporate operations from asset holding entities in group structures* (December 2021) 17-19 <https://clrg.org/publications/clrg-report-on-insolvency-issues.pdf> accessed 6 September 2022.

[14] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L172/18.

[15] European Union (Preventive Restructuring) Regulations 2022, SI 2022/380 <https://enterprise.gov.ie/en/legislation/legislation-files/si-no-380-of-2022.pdf> accessed 3 January 2023.

[16] Corporate Enforcement Authority, *Information Note 2023/1 on European Union (Preventive Restructuring) Regulations 2022: Early Warning Tools and Restructuring Frameworks* (Corporate Enforcement Authority, 2023) 4 <https://cea.gov.ie/Portals/0/Information%20Notes/Information%20Note%202023_1%20PRD%20FINAL.pdf?ver=vjIczTMIY2EloUrBrgc6CQ%3d%3d> accessed 3 January 2023 (CEA Information Note 2023/1).

[17] That is, balance sheet insolvent. See, James Morrin, 'Directors' Duties and Responsibilities when Financial Difficulties Arise' (Mason, Hayes and Curran LLP, 9 January 2023) <https://www.mhc.ie/latest/insights/directors-duties-and-responsibilities-when-financial-difficulties-arise> accessed 11 January 2023.

[18] [2022] UKSC 25, [2022] 3 WLR 709 (Sequana).

[19] Companies Act (UK) 2006, s 172(3).

[20] One distinction is in the text of the UK provision compared to the Irish provision. The UK provision – Companies Act (UK) 2006, s 172(3) – provides that "[t]he duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company". The UK provision may therefore be described as merely a statement of the duty to consider the interests of creditors in UK law without giving details as regards when the duty arises. For details such as this, the UK provision seems to implicitly refer readers to cases like *West Mercia Safetywear Ltd v. Dodd* [1988] 4 BCC 30 which established the duty and others like the recent *Sequana* case. As we have seen, the new Irish provision, on the other hand, states that directors owe a duty to consider the interests of creditors and also gives details of when this duty is triggered. Although there is some ambiguity as to when the duty arises (see, Section V above), the reference to S 509(3) in the Irish provision goes some way towards narrowing this enquiry. See further, Michael Murphy, Lisa Smyth, and David O'Dea, 'Directors' duty to have regard to the interests of creditors: Irish and English law contrasted' (McCann Fitzgerald LLP, 17 October 2023) <https://www.mccannfitzgerald.com/knowledge/restructuring-and-insolvency/directors-duty-to-have-regard-to-the-interests-of-creditors-irish-and-english-law-contrasted> accessed 19 January 2023 (McCann Fitzgerald).

[21] Sequana (n 17) 768.

[22] Companies Act 2014, s 224A(2).

[23] Tom Courtney, *The Law of Companies* (4th edn, Bloomsbury Professional 2016) para 16.030.

[24] [1902] 2 Ch 421.

[25] *Salomon v. A. Salomon & Co. LTD* [1897] AC 22.

[26] Companies Act 2014, s 227(1) provides that "a director of a company shall owe the duties set out in *section 228* to the company (and the company alone)".

[27] Companies Act 2014, s 224 provides that:

> (1) The matters to which the directors of a company are to have regard in the performance of their functions shall include the interests of the company's employees in general, as well as the interests of its members.
>
> (2) Accordingly, the duty imposed by this section on the directors shall be owed by them to the company (and the company alone) and shall be enforceable in the same way as any other fiduciary duty owed to a company by its directors.

[28] [2022] IEHC 505.

[29] ibid [170].

[30] ibid [159].

[31] Irene Lynch Fannon and Gerard Murphy, *Corporate Insolvency and Rescue* (2nd edn, Bloomsbury Professional 2012) para 12.18.

[32] CEA Information Note 2023/1 (n 16) 9.

[33] ibid 4.

[34] "belief, n." *OED Online*, Oxford University Press, December 2022 <www.oed.com/view/Entry/17368> accessed 20 January 2023.

[35] "aware, adj." *OED Online*, Oxford University Press, December 2022 <www.oed.com/view/Entry/13892> accessed 20 January 2023.

[36] The following is from an Information Booklet issued by the Department of Enterprise, Trade and Employment that accompanied the European Union (Preventive Restructuring) Regulations 2022: "Regulation 5 provide[s] further amendments to the Companies Act to include this duty to creditors in the list of fiduciary duties owed to the company". This suggests that Regulation 5 provided for at Section 228(1)(h)(i) of the Act is intended to be supportive or facilitative of Regulation 4 found at Section 224A of the Act. See, Department of Enterprise, Trade and Employment, 'European Union (Preventive Restructuring) Regulations 2022 Information Note' (October 2022) <https://enterprise.gov.ie/en/publications/publication-files/european-union-preventive-restructuring-regulations-2022-information-note.pdf> accessed 3 January 2023.

[37] See generally, McCann Fitzgerald (n 20).