

CORPORATE FAILURE AND DIRECTORS' DUTIES: TOWARDS A
PARADIGM OF FINANCIAL STAKEHOLDING

DR. FRANCIS OKANIGBUAN^{*†}

^{*}Senior Lecturer, Centre for the Study of Law in Theory and Practice, School of Law and Justice Studies, Liverpool John Moores University. I am grateful to the anonymous reviewers of the initial drafts of this article. Special thanks to Trading Economics, New York City, for permission to use the data in Table 1.

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ABSTRACT

By reference to the financial stakeholding analytical framework, this article challenges the capacity of directors to ensure that creditor interests are not undermined whilst promoting the interests of shareholders when an entity is undergoing financial challenges. In the United Kingdom and Delaware, directors' duties are required to be exercised in furtherance of shareholder interests. This is justified since shareholders are financial stakeholders. However, since the financial stakeholder platform is jointly shared with creditors, it is equally justifiable to protect creditor interests, especially unsecured creditors. This article argues that the recurrent corporate failures and exposure of unsecured creditors to risks indicate the limited capacity of directors to preserve creditor interests whilst promoting shareholder interests when an entity encounters financial challenges. Therefore, this article suggests that a designated independent non-executive director should be required to lead the role of preserving creditor interests when an entity encounters serious financial challenges.

Keywords: *financial-stakeholding; creditors; corporate failures; directors' duties; shareholders; insolvency; independent non-executive director*

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I. INTRODUCTION

In the United Kingdom and Delaware, directors are required to act as fiduciaries and exercise reasonable care, skill, and diligence in the discharge of their duties.¹ These duties are owed to the company,² but exercised in the interest of shareholders.³ The duties which are part of mainstream company law are complemented by corporate governance regulations in the U.K., which are similarly aimed at promoting shareholder interests.⁴ Further, while board effectiveness is considered an essential requirement for the sustainability of corporate entities, non-executive directors ("NEDs"), who significantly contribute to board effectiveness⁵ appear to steer the objectives of board effectiveness towards promoting shareholder interests. For example, NEDs are appointed to promote board effectiveness and objectivity, ensuring that the corporation promotes value for shareholders.⁷ Sources indicate that the interests of shareholders invariably shape the role of boards, and the combined effects of corporate law and corporate governance regulations mainly promote shareholder interests.

Recently, the U.K. Supreme Court in *BTI 2014 LLC v Sequana*, held that it is liquidation rather than insolvency or the risk of insolvency that converts creditors into the main stakeholders in the company.⁸ The apex court held that when a company is undergoing financial difficulties, and before liquidation becomes inevitable, "the creditor duty is a duty to consider creditors' interests, to give them appropriate weight, and to balance them against shareholders' interests where they may conflict."⁹

¹Companies Act 2006, c. 46, §§ 171–77 (UK); see *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); see also *McMullin v. Beran*, 765 A.2d 910, 917 (Del. 2000).

²Companies Act 2006, c. 46, § 170(1) (UK); see *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).

³Companies Act 2006, c. 46, § 172(1) (UK); see *Harris*, 582 A.2d at 234.

⁴See FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE, 2–4 (2018), https://media.frc.org.uk/documents/UK_Corporate_Governance_Code_2018.pdf.

⁵See generally FIN. REPORTING COUNCIL, GUIDANCE ON BOARD EFFECTIVENESS (2018), <https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-guidance-on-board-effectiveness-final.pdf> (last visited Dec. 2023); see John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 BUS. LAW. 421, 448–51 (2004).

⁶Andrew Kakabadse et al., *Role and Contribution of Non-Executive Directors*, 1 CORP. GOVERNANCE 4, 6–7 (2001); Thomas Clarke, *The Contribution of Non-Executive Directors to The Effectiveness of Corporate Governance*, 3 CAREER DEV. INT'L 118, 119–21 (1998).

⁷FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE 4, Principle A (2018); see *id.* at 2.

⁸*BTI 2014 LLC v. Sequana SA and others* [2022] UKSC 25, [165], [199], [202], [306] (appeal taken from EWCA).

⁹*Sequana*, [2022] UKSC 25 at [176].

The court acknowledged that while undergoing such financial difficulty, "the economic interest of [a company's] creditors become distinct from those of its shareholders, and are liable to become increasingly predominant as the company's situation deteriorates"; nevertheless, "the predominant interest will normally continue to be held by shareholders[.]"¹⁰ This implies that directors are to merely consider the interests of creditors and balance the interests of financial stakeholders as required by statute,¹¹ while promoting the corporate objective for shareholder interests.¹²

In Delaware, directors consider creditor interests to the extent of avoiding personal liability for their conduct, such as paying unlawful dividends when the company was on the verge of insolvency, if the company eventually becomes insolvent.¹³ In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the Delaware Supreme Court held that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency.¹⁴ The court held that directors are generally required to continue to promote the corporate interests for the benefit of shareholders before insolvent liquidation, even though the entity encounters financial difficulty.¹⁵

The decisions of the courts above indicate limited protection for creditors in both jurisdictions, especially unsecured creditors. It has been suggested that the discretionary powers of directors exercising business judgment would enable them to balance the competing interests of shareholders and creditors.¹⁶ Alternatively, it has been argued that a custodial duty of caution should replace directors' entrepreneurial duty when an entity is in the zone of insolvency!¹⁷ However, the extent to which directors can effectively and objectively exercise business judgment or replace their entrepreneurial duty with a custodial duty of caution when a corporation struggles financially is doubtful. Directors are accustomed to promoting shareholder interests; hence, directors lack the capacity to be

¹⁰*Sequana*, [2022] UKSC 25 at [83].

¹¹Companies Act 2006, c. 46, § 172(3) (UK).

¹²*Sequana*, [2022] UKSC 25 at [83].

¹³DEL. CODE ANN. tit. 8, §§ 170, 174.

¹⁴*N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007).

¹⁵*Id.* at 101.

¹⁶Philip Gavin, *A Rejection of Absolutist Duties as a Barrier to Creditor Protection: Facilitating Directorial Decisiveness Surrounding Insolvency Through the Business Judgment Rule*, 15 BROOK. J. CORP. FIN. & COM. L. 313 (2021).

¹⁷Amir N. Licht, *My Creditor's Keeper: Escalation of Commitment and Custodial Fiduciary Duties in the Vicinity of Insolvency*, 98 WASH. U. L. REV. 1731, 1749–53 (2021).

objective in balancing shareholders and creditor interests.¹⁸ This is particularly evident, firstly, as a result of the continuous increase in corporate failures caused by avoidable insolvencies,¹⁹ and, secondly, in view of the shareholder approach to corporate regulation,²⁰ even though directors would likely know how to protect creditors interests, having the requisite corporate experience. The decisions of the Supreme Courts of the U.K. and Delaware may further encourage directors and shareholders to reject external interferences outside the board that attempt to tame shareholder and directors' entrepreneurial objectives while in the zone of insolvency.²¹ Therefore, this article suggests that a designated independent non-executive director ("INED") should be required to determine the extent to which creditor interests are preserved when directors make decisions in the zone of insolvency. This requirement would ensure that while the board retains its powers to manage the business of the company, the burdensome expectations of the board to preserve creditor interests would be activated and monitored by the INED. The INED's role would help the board, as a whole, to achieve this objective.

The justifications for this analysis include the following: Firstly, both shareholders and creditors are financial stakeholders²² and capital contributors; secondly, failure to promote short-term shareholder interests is unlikely to lead to the demise of the corporation, whereas failure to preserve creditor interests could lead to insolvency. Thus, it is imperative to preserve creditor interests before they become paramount. The role of the designated INED would generally be a preventive measure. It would act as an incentive for directors to develop effective internal control measures that would keep the entity's debt level below the threshold of the undesirable gearing ratio that could lead to insolvency, thereby ensuring that the role of the INED is never triggered.

The remainder of this article is presented as follows: The Methodology section highlights the justifications for the comparative study, with data indicating the continuous increase in corporate failures in the U.K. and the U.S.; Part II outlines the position of shareholders and

¹⁸Gavin, *supra* note 16, at 315–25.

¹⁹See *infra* Table 1.

²⁰See *infra* Part II; see also Andrew Keay, *Formulating a Framework for Directors' Duties to Creditors: An Entity Maximisation Approach* 64 CAMBRIDGE L. J. 614, 626 (2005).

²¹See Licht, *supra* note 17, at 1753.

²²See generally Niamh M. Brennan & Doris M. Merkl -Davies, *Do Firms Effectively Communicate with Financial Stakeholders? A Conceptual Model of Corporate Communication in a Capital Market Context*, 48 ACCT. & BUS. RSCH. 553 (2018) (describing shareholders and creditors as financial stakeholders in a corporation, or important stakeholders in the company's assets, since they particularly invest financial resources in corporations, unlike other stakeholders); see also Jacob S. Ziegel, *Creditors as Corporate Stakeholders: The Quiet Revolution, An Anglo-Canadian Perspective*, 43 U. TORO. L. J. 511 (1993).

creditors as financial stakeholders of the corporation and analyzes the effects of the dominant influence of shareholders over the corporation; Part III examines the limitations of directors' duties in preserving the interests of creditors before they become paramount at insolvency; and, finally, Part IV argues that the problem of corporate failures is manifested in the performance of directors' duties when creditor interests are undermined.

II. METHODOLOGY

A review of corporate insolvencies among G20 countries indicates that the U.K. and the U.S. account for the highest number of corporate insolvencies as of April 2020.²³ The G20 countries represent the most industrialised countries worldwide.²⁴ It is a relevant platform for assessing statistical information about corporate insolvencies, since the countries that make up the group are home to most corporate entities, globally.²⁵ For example, the G20 make up about 85% of the world economy and about three-quarters of global trade.²⁶ Table 1 below from *Trading Economics* New York, shows a list of insolvencies in G20 countries, and different reference periods for those countries.²⁷ The earliest period of corporate insolvency is reported as June 2019 for Italy.²⁸ The latest corporate insolvencies were reported as April 2020 for Japan, the Netherlands, Singapore, and South Korea.²⁹ The highest figure of 13,840 insolvencies is reported for Switzerland; however, this figure includes individual and corporate insolvencies.³⁰ The U.S. and the U.K. were identified as the countries with the highest corporate insolvencies, with figures of 23,114 and 3,883 respectively, reported in March 2020.³¹

In the U.S., while partly regulated by federal law, companies are also regulated by state law, especially in regard to directors' duties.³² It is

²³See *infra* Table 1; *Bankruptcies Reported in G20 Countries*, TRADING ECON., <https://tradingeconomics.com/country-list/bankruptcies?continent=g20> (last visited Sep. 15, 2020) (cited with permission from Trading Economics, New York).

²⁴See Rosamond Hutt, *What is the G20 and Why Does it Matter?*, WORLD ECON. F. (Nov. 15, 2024), <https://www.weforum.org/stories/2024/11/g20-summit-what-you-need-to-know/> [<https://perma.cc/V59Z-2PU9>].

²⁵See *id.*; see also *infra* Table 1.

²⁶See Hutt, *supra* note 24.

²⁷*Infra* Table 1.

²⁸*Infra* Table 1.

²⁹*Infra* Table 1.

³⁰*Infra* Table 1.

³¹*Infra* Table 1.

³²See Holly J. Gregory, Rebecca Grapsas, & Claire H. Holland, *Corporate Governance and Directors' Duties in the United States: Overview*, PRAC. L. (Sep. 1, 2021), <https://law>

beyond the scope of this study to examine corporate regulation relating to directors' duties across all the states in the U.S. Delaware was therefore considered and compared with the U.K. for the following reasons.

Unlike other states, Delaware is home to 68% of Fortune 500 companies and 93% of all U.S.-based initial public offerings (public companies).³³ Delaware also offers immense corporate tax benefits, and its Court of Chancery is widely recognised for resolving corporate disputes.³⁴ These benefits make Delaware an attractive state and a prime choice for corporate registration in the United States.³⁵ Even though directors in both the U.K. and Delaware owe their duties to their companies, directors' duties are exercised in the interest of shareholders in both jurisdictions.³⁶ Essentially, both the U.K. and Delaware require directors to promote shareholder interests.³⁷

The U.K. and Delaware Supreme Courts have held that directors' duties remain owed to shareholders even though a company is undergoing financial challenges.³⁸ In the U.K. and U.S. broadly, Delaware inclusive, unsecured creditors are likely to recover little or nothing from insolvent companies.³⁹ Their claims usually rank lower than the claims of other creditors.⁴⁰ The *pari passu* principle, which applies in the U.K., seeks to ensure that unsecured creditors share rateably in the assets of the insolvent company that are available for residual distribution.⁴¹ The rateable distribution requirement of the *pari passu* principle is an acknowledgement that unsecured creditors have limited chances of being paid the full sums owed to them, hence the need for proportional payments

.stanford.edu/wp-content/uploads/2023/01/Corporate-Governance-and-Directors-Duties-in-the-United-States-Overview.pdf [https://perma.cc/AQ4B-PYDP].

³³See Chauncey Crail, Rob Watts & Jane Haskins, *Why Incorporate in Delaware? Benefits and Considerations* FORBES (Feb. 15, 2024), <https://www.forbes.com/advisor/business/incorporating-in-delaware/#:~:text=The%20most%20famous%20reason%20Delaware,not%20pay%20corporate%20income%20tax>.

³⁴See *id.*

³⁵See *id.*

³⁶See Companies Act 2006, c. 46, §§ 170, 172 (UK); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

³⁷See Companies Act 2006, c. 46, §§ 170, 172 (UK); *Malone*, 722 A.2d at 10.

³⁸See *Gheewalla*, 930 A.2d at 98; *Sequana*, [2022] UKSC 25 at [3].

³⁹See *Central Government Guidance on Corporate Financial Distress (HTML)*, GOV.UK (June 20, 2023) [hereinafter *Central Government Guidance*], https://www.gov.uk/government/publications/corporate-financial-distress/central-government-guidance-on-corporate-financial-distress-html?utm_source=chatgpt.com [https://perma.cc/B9GL-2R2F]; Alessandra Allegretto, *Overcoming Creditor Misfortune Creatively: Structured Dismissals in Chapter 11 Bankruptcies*, 2 J. L. & COM. 239, 242 (2018).

⁴⁰See *Central Government Guidance*, *supra* note 39; see also Allegretto, *supra* note 39.

⁴¹See *Re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711.

to be made on the basis of the *pari passu* principle.⁴² Similarly, in the U.S., Delaware inclusive, unsecured creditors rank below preferential creditors.⁴³ Priority among unsecured creditors is outlined in statute;⁴⁴ payments are required to be made on a fractional basis to certain unsecured creditors.⁴⁵ The requirement for fractional payment is not just an indication that certain unsecured creditors may not be paid, like the *pari passu* principle. Instead, it shows the limitation of regulation in protecting unsecured creditors at insolvency, despite their position as joint financial stakeholders with shareholders and secured creditors.⁴⁶

The level of insolvency in the U.K. and the U.S., and the position of Delaware, justify the comparative analysis of the role of directors in both jurisdictions in relation to the link between corporate failures, directors' duties, and creditor interests. Both jurisdictions were therefore compared to ascertain the extent to which the similarity in the regulation of the role of directors in relation to shareholder and creditors interests encourages directors to engage in risks that may ultimately undermine creditor interests and overriding corporate interests.

⁴²VANESSA FINCH & DAVID MILMAN, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 511–35 (3d ed. 2017).

⁴³See, e.g., *Long v. Bullard*, 117 U.S. 617, 620–21 (1886); *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992); *Investor Bulletin: Bankruptcy for a Public Company*, U.S. SEC. & EXCH. COMM'N (Mar. 31, 2015), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-84>.

⁴⁴See 11 U.S.C. § 507.

⁴⁵See *id.* § 507(4).

⁴⁶See *Central Government Guidance*, *supra* note 39; see also *Allegretto*, *supra* note 39.

***TABLE 1 Bankruptcies Reported in G20 Countries**

Country	Last	Previous	Reference	Unit
<u>Australia</u>	683	667	Mar/20	Companies
<u>Canada</u>	175	233	Mar/20	Companies
<u>France</u>	268	282	Dec/19	Companies
<u>Germany</u>	1529	1609	Feb/20	Companies
<u>Italy</u>	2844	2823	Jun/19	Companies
<u>Japan</u>	743	740	Apr/20	Companies
<u>Netherlands</u>	395	361	Apr/20	Companies
<u>Russia</u>	2538	3145	Mar/20	Companies
<u>Singapore</u>	22	91	Apr/20	Companies
<u>South Africa</u>	164	125	Feb/20	Companies
<u>South Korea</u>	24	28	Apr/20	Companies
<u>Spain</u>	1501	1979	Mar/20	Companies
<u>Switzerland</u>	13840	13971	Dec/19	Companies and Individuals
<u>Turkey</u>	821	865	Mar/20	Companies
<u>United Kingdom</u>	3883	4284	Mar/20	Companies
<u>United States</u>	23114	22780	Mar/20	Companies

Source – *Trading Economics*⁴⁷

Table 1 above shows a list of corporate insolvencies among G20 countries as of April 2020.⁴⁸ It shows that the U.S. and the U.K. account for the highest number of corporate insolvencies among the most industrialized countries worldwide.⁴⁹ Switzerland shows the overall highest number of combined figures for individual and corporate insolvencies.⁵⁰

III. FINANCIAL STAKEHOLDING AND THE CORPORATE INTEREST

Although directors' duties are owed to the company, the duty to promote the success of the company is to be exercised for the ultimate benefit of members of the company.⁵¹ Directors in the U.K. are

⁴⁷*Bankruptcies Reported in G20 Countries*, TRADING ECON., <https://tradingeconomics.com/country-list/bankruptcies?continent=g20> (last visited Sep. 15, 2020) (cited with permission from Trading Economics, New York).

⁴⁸*Supra* Table 1.

⁴⁹*Supra* Table 1.

⁵⁰*Supra* Table 1.

⁵¹See Companies Act 2006, c. 46, §§ 170, 172 (UK); *Malone*, 722 A.2d at 10 (Del. 1998); *McMullin*, 765 A.2d at 917; *Harris*, 582 A.2d at 234.

nevertheless required to consider the likely consequences of any decision in the long-term, as well as the interests of other stakeholders, namely: creditors, employees, the community, and suppliers, among others.⁵² However, in view of the dominant influence of shareholders over the role of directors, directors are constrained to mainly focus on promoting shareholder interests.⁵³ For example, in the U.K. and Delaware, shareholders retain powers to appoint and remove directors at any time, irrespective of the duration of the directors' employment contracts.⁵⁴ Other areas of shareholder dominance include the power to amend the corporation's articles of incorporation and bylaws; and the ability to approve certain transactions, such as substantial property transactions, loans and quasi-loans to directors, and directors' service contracts longer than two years.⁵⁵ These considerations clearly indicate that the approach of mainstream corporate law does not create any doubt that the interests of shareholders are paramount to the objectives of a corporation. Meanwhile, after incorporation, creditors provide debt capital to finance the business of corporate entities.⁵⁶ Creditors are interested in the long-term success of corporate entities because long-term corporate success increases the likelihood that creditors will recover their debt capital.⁵⁷ Companies become insolvent either because of their inability to meet their debt obligations when due or demanded by creditors, or when liabilities exceed assets.⁵⁸ Although the corporate interest may be rightly equated with shareholder interests when the corporation is solvent, and with creditor interests when it is insolvent, creditors have an interest in the corporation remaining solvent for the long-term and perhaps indefinitely.⁵⁹ A corporation that can remain solvent is more likely to meet its debt

⁵²See Companies Act 2006, c. 46, §172 (1)(a)–(f) (UK).

⁵³See *id.* § 172(3); *Sequana*, [2022] UKSC 25; see also *UK Supreme Court Clarifies Directors' Duties to Consider Creditors' Interests Where Risk of Insolvency is Imminent*, COVINGTON (Oct. 13, 2022), <https://www.cov.com/en/news-and-insights/insights/2022/10/uk-supreme-court-clarifies-directors-duties-to-consider-creditors-interests-where-risk-of-insolvency-is-imminent> (explaining the relevance and holding of *Sequana*).

⁵⁴Companies Act 2006, c. 46, § 168 (UK); DEL. CODE ANN. tit. 8, § 141 (b) & (k) (West 2020).

⁵⁵See Companies Act 2006, c. 46, §§ 21, 188, 190–91, 197–98 (UK); Tit. 8, §§ 109, 144–45.

⁵⁶See Insolvency Act 1986, c. 45, §107 (UK).

⁵⁷See George S. Dallas, *The Role of the Creditor in Corporate Governance and Investor Stewardship*, HARV. L. SCH. F. CORP. GOVERNANCE (Oct. 9, 2019), <https://corpgov.law.harvard.edu/2019/10/09/the-role-of-the-creditor-in-corporate-governance-and-investor-stewardship/>.

⁵⁸See Insolvency Act 1986, c. 45, § 123 (UK); 11 U.S.C. § 101(32); JOHN BIRDS ET AL., *BOYLE & BIRDS' COMPANY LAW* 813 (7th ed. 2009).

⁵⁹Andrew Keay & Sulette Lombard, *Financial Distressed Companies and Directors' Obligation to Consider Creditors' Interests: An Anglo-Australian Comparison of the Obligation's Trigger and Application*, 53(3) COMMON L. WORLD REV. 107, 123 (2024).

obligations, indicating a stronger bond between creditor interests and the long-term corporate interest as a going concern.⁶⁰ Despite the extensive framework of corporate regulations, corporate failures persist.⁶¹ While shareholders may suffer limited losses from corporate failures in view of the doctrine of separate legal personality, the extent to which creditors, especially unsecured creditors, are protected from losses is largely unclear.⁶²

The interest of shareholders which is promoted by the approach to corporate regulation indicates that the attitude of the board should not be the focus of our attention. Boards, including NEDs, are constrained to act according to the regulatory approach that promotes shareholder interests.⁶³ Particularly, active shareholder engagement with boards to address the problems of agency conflict may further influence the supervisory role of the board towards promoting shareholder interests.⁶⁴ It has been suggested that greater shareholder protection and power is associated with higher economic growth;⁶⁵ nevertheless, it is necessary to ensure that shareholder dominance does not invariably undermine the interests of other stakeholders when a conflict of interest arises.⁶⁶ This appears to have been attempted through the enlightened shareholder value ("ESV") approach in the U.K.⁶⁷ However, the ESV merely requires directors to consider the interests of other stakeholders, such as employees and creditors, among others, without the requirement to positively promote the wider corporate interests.⁶⁸ Thus, it was rightly argued that it is unlikely that the ESV will make any considerable difference in fostering long-term corporate interests.⁶⁹ Further, it has been suggested that the complex nature of short-termism is related to the rights and responsibilities of corporate stakeholders, affecting the checks and balances between the stakeholders in ways to assure that stakeholders with long-term interests are given

⁶⁰See Keay & Lombard, *supra* note 59.

⁶¹See *supra* Table 1.

⁶²See Companies Act 2006, c. 46 (UK).

⁶³See *id.* § 172(1); see also Harris, 582 A.2d at 234.

⁶⁴See *The Role of Activist Investors in Shaping Corporate Governance: How Shareholder Activism Drives Changes in Governance Policies*, DIR.'S INST. (Sep. 27, 2024), <https://www.directors-institute.com/post/the-role-of-activist-investors-in-shaping-corporate-governance-how-shareholder-activism-drives-chan>.

⁶⁵George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 141-49 (2010).

⁶⁶See Edward R. Freeman, Andrew C. Wicks & Bidhan Parmar, *Stakeholder Theory and The Corporate Objective Revisited*, 15 ORG. SCI. 364, 365-66 (2004).

⁶⁷See Companies Act 2006, c. 46, § 172(1) (UK).

⁶⁸See *id.*

⁶⁹See Andrew Keay, *Risk, Shareholder Pressure and Short-Termism in Financial Institutions: Does Enlightened Shareholder Value Offer A Panacea?*, 5 L. & FIN. MKTS. REV. 435, 443 (2011).

sufficient voice in decision-making.⁷⁰ This reflects the argument that the interests of stakeholders with long-term corporate objectives may not necessarily undermine the interests of stakeholders with short-term objectives.⁷¹ The long-term objectives may delay the actualisation of short-term objectives without necessarily preventing the actualisation of the short-term objectives.⁷² Whereas short-term objectives may truncate the actualisation of the objectives of long-term corporate stakeholders.⁷³ Conflicts of interest between shareholders and managers, and between short-term and long-term corporate value, are expected to be addressed by the board generally and by independent directors particularly.⁷⁴ However, the extent to which directors can effectively foster cohesion and unify various interests in the company is not without challenges, particularly because of the dominant influence of the shareholder approach to corporate regulation and administration. The limitations of directors in preserving creditor interest before creditors interests become paramount at insolvency. These limitations are examined next, particularly in relation to the U.K. and Delaware. The analyses justify the need to strengthen the board in preserving creditor interests before they become paramount at insolvency.

IV. DIRECTORS' DUTIES AND CREDITOR INTEREST

A. *The United Kingdom*

When a company becomes insolvent, unsecured creditors may be exposed to the risk of non-payment of part of their debt capital, since they rank below secured and other preferential creditors⁷⁵ and they are not quite protected by the applicable *pari passu* principle.⁷⁶ The *pari passu* principle seeks to ensure that unsecured creditors share rateably in the assets of the

⁷⁰Gregory Jackson & Anastasia Petraki, *How Does Corporate Governance Leads to Short-Termism?*, 1 THE SUSTAINABLE CO.: A NEW APPROACH TO CORP. GOVERNANCE 199, 218 (Sigurt Vitols & Norbert Kluge eds. 2011).

⁷¹See David A. Katz et al., *The Long Term, The Short Term, and The Strategic Term*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sep. 27, 2019), <https://corpgov.law.harvard.edu/2019/09/27/the-long-term-the-short-term-and-the-strategic-term/>.

⁷²See Jesse M. Fried, *The Uneasy Case for Favoring Longterm Shareholders* 124 YALE L. J. 1554, 1562–63 (2015).

⁷³See *id.*

⁷⁴See *Principles of Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sep. 8, 2016), <https://corpgov.law.harvard.edu/2019/09/27/the-long-term-the-short-term-and-the-strategic-term/>.

⁷⁵Insolvency Act 1986, c. 45, §§ 107, 115, 143, 156, 175 (UK).

⁷⁶See FINCH & MILMAN, *supra* note 42.

insolvent company that are available for residual distribution.⁷⁷ The rateable distribution requirement of the *pari passu* principle is an acknowledgement that unsecured creditors have limited chances of being paid the full sums owed to them.⁷⁸ Since corporate insolvency refers to the inability of a corporate entity to meet its debt obligations, or where liability exceeds its assets,⁷⁹ the interests of unsecured creditors are almost certainly disregarded as soon as a company is insolvent.

To avoid the undesirable effect of corporate insolvency on creditors, when a company is solvent, directors are required to consider the interests of creditors when they promote shareholder interests.⁸⁰ Directors are also required to be mindful of regulations that seek to particularly protect the interests of creditors in certain circumstances.⁸¹ For example, when a company is insolvent, the requirement that directors act in the interest of creditors applies, their duty shifts, and it supersedes the provision that requires directors to promote the success of a company for the benefit of the members as a whole.⁸²

However, the former requirement of § 172(3) of the Companies Act, that directors "consider" the interests of creditors, applies mainly in relation to fraudulent trading⁸³ and wrongful trading⁸⁴ provisions under the Insolvency Act 1986. Under this requirement, directors may be held liable for failing to consider the interests of creditors when a company encounters financial challenges, if the company eventually becomes insolvent. It is relatively straight forward that the interests of creditors are paramount at insolvency.⁸⁵ The main challenge emerges pre -insolvency, i.e., when a corporation encounters serious financial difficulties, but it is not yet insolvent. At this stage, shareholder interests remain paramount, and directors are merely required to consider the interests of creditors.⁸⁶ Since shareholder interests remain paramount and directors are merely required to consider creditor interests, it is doubtful whether directors, that

⁷⁷FINCH & MILMAN, *supra* note 42, at 511; *Gray's Inn Construction*, [1980] 1 WLR 711.

⁷⁸FINCH & MILMAN, *supra* note 42, at 511–25.

⁷⁹11 U.S.C. § 101(32); Insolvency Act 1986, c. 45, § 123 (UK); *BIRDS ET AL.*, *supra* note 58.

⁸⁰Companies Act 2006 c. 46, § 172(3) (UK).

⁸¹*Id.*

⁸²*Id.* § 172(1).

⁸³*Id.* § 172(3); Insolvency Act 1986, c. 45, § 213 (UK).

⁸⁴Insolvency Act 1986, c. 45, § 214 (UK).

⁸⁵See *Sequana*, [2022] UKSC 25; *Colin Gwyer & Assoc. Ltd. v. Lond. Wharf (Limehouse) Ltd.* [2003] BCC 885 (UK); *Re Oxford Pharm. Ltd.* [2009] EWHC 1753 (Ch) (UK); *Roberts v. Frohlich* [2011] EWHC 257 (Ch) (UK); *Re HLC Env 't Projects Ltd.* [2013] EWHC 2876 (Ch) (UK).

⁸⁶*Sequana*, [2022] UKSC 25 at [81].

are required to promote shareholder interests, can objectively and effectively consider and preserve creditor interests, especially in view of the high rate of insolvency. Recently, the U.K. Supreme Court held in *BTI 2014 LLC v. Sequana SA* that when a company is either insolvent or bordering on insolvency, but is not faced with an inevitable insolvent liquidation or administration, directors should consider the interests of creditors by balancing them against the interests of shareholders.⁸⁷ In *Sequana*, the assignees of the claim challenged the payment of dividends on the basis, among other grounds, that by causing the company to pay the dividends, the directors were in breach of their duty to balance stakeholder interests.⁸⁸ In May 2009, AWA's directors, who are the second and third respondents, caused the company to distribute a dividend of €135m (the "May Dividend") to its only shareholder, the first respondent, Sequana SA.⁸⁹ This payment extinguished, by way of set-off, almost the whole of a slightly larger debt which Sequana owed to AWA.⁹⁰ There was a real risk that AWA might become insolvent in the future, though insolvency was not imminent at the time.⁹¹ Nearly ten years later, in October 2018, AWA went into insolvent administration.⁹² The appellant, BTI 2014 LLC ("BTI") the assignee of AWA's claims, sought to recover the amount of the May Dividend from AWA's directors. ⁹³ BTI argued that the decision of the directors to distribute the May dividend was taken in breach of the creditor duty because the directors had not considered or acted in the interest of AWA's creditors.⁹⁴ In holding that AWA's directors were not, at the relevant time, under a duty to consider the interests of creditors, and consequently not liable, the U.K. Supreme Court provided certain reasons for its decision.⁹⁵

Firstly, the Supreme Court held that the directors' duty to promote the success of the company for the benefit of its members as a whole under § 172(1)⁹⁶ is, in certain circumstances, modified to indicate that the company's interests are taken to include the interests of the company's creditors as a whole. ⁹⁷ The Court indicated that although directors are required to consider creditors' interests, it is not a free-standing duty owed

⁸⁷*Sequana*, [2022] UKSC 25 at [81]; see also *Bilta (UK) Ltd. (in liquidation) v. Nazir* [2013] EWCA 968 (Civ).

⁸⁸*Sequana*, [2022] UKSC 25 at [115]–[117].

⁸⁹*Id.*

⁹⁰*Id.* at [115].

⁹¹*Id.*

⁹²*Sequana*, [2022] UKSC 25 at [115].

⁹³See *Sequana*, [2022] UKSC 25.

⁹⁴*Id.* at [115]–[117].

⁹⁵*Id.*

⁹⁶Companies Act 2006, c. 46, § 172(1) (UK).

⁹⁷*Sequana*, [2022] UKSC 25 at [11].

directly to creditors.⁹⁸ Thus, directors do not owe their duty directly to creditors; they are to exercise their duty to the company to indirectly promote the interests of creditors when the duty to consider creditor interests is triggered. Secondly, the duty to consider creditors' interests was not triggered in *Sequana* because AWA was not insolvent or imminently insolvent at the time the dividend was paid.⁹⁹ The court held that the duty to consider or promote creditors' interests does not apply merely because there is a real, and not remote, risk of insolvency. Lord Reed observed:

As has been explained, as long as the company is financially stable, its shareholders will normally have a predominant economic interest in the manner in which its affairs are managed, and their interests will normally be aligned with those of its creditors. When the company is in financial difficulties, however, the economic interest of its creditors become distinct from those of its shareholders, and are liable to become increasingly predominant as the company's situation deteriorates. That shift in interests does not occur merely because there is a real but not remote risk of insolvency. In that eventuality, the predominant interest will normally continue to be held by the shareholders, and the interests of creditors will not require separate consideration.¹⁰⁰

Creditor interests only become paramount when an insolvent liquidation or administration is inevitable, as the shareholders cease to retain any valuable interest in the company.¹⁰¹ This implies that directors' duties should only be exercised in furtherance of creditor interests when a corporation is insolvent. In other instances, such as those presented in *Sequana*, shareholder interests would be predominantly promoted, and directors would merely consider creditor interests. The difference between the duty to consider creditor interests and the duty to actively promote creditor interests was also explained by the U. K. Supreme Court.¹⁰² The duty to consider creditor interests allows directors to assume a wide discretion as to the particular weight to be given to creditor interests when balancing them against the potentially conflicting interests of another class, such as shareholders.¹⁰³ Whereas the duty to promote creditor

⁹⁸*Sequana*, [2022] UKSC 25 at [11], [112], [205].

⁹⁹*Id.* at [116].

¹⁰⁰*Id.* at [83].

¹⁰¹*Id.* at [81].

¹⁰²*Sequana*, [2022] UKSC 25 at [11].

¹⁰³*Id.* at [81].

interests suggests that creditors interests predominate, if it conflicts with the interests of others, e.g., shareholders.¹⁰⁴ In *Sequana*, neither of these aspects of the duty was held to have been breached by the directors of AWA.¹⁰⁵

Despite the decision of the court that directors' duties are owed to the company and not to shareholders or creditors directly, shareholders are empowered to influence directors' duties to promote their own interests before they are undermined by directors ; whereas creditors, especially unsecured creditors, lack the capacity to effectively protect their interests.¹⁰⁶ Since the U.K. Supreme Court has confirmed that the directors' duty to consider creditors' interests is not a free -standing duty and that a specific duty to creditors is not triggered unless the company is insolvent, the *status quo* is preserved.¹⁰⁷ Several creditors will likely continue to experience the challenges that they were exposed to, prior to the decision of the U.K. Supreme Court. Those creditors would likely be unable to prevent their interests from being undermined before it becomes paramount, as shown in the analysis of the limitations of the *pari passu* principle above.¹⁰⁸

The deficiency of the argument that creditors should protect their interests via contract has already been addressed!¹⁰⁹ If creditors could protect their interests via contract, or even by proprietary means, there would be no need for statutory and common law protection.¹¹⁰ Also, shareholders do not rely on contracts for protection, because are protected by law.¹¹¹ Since shareholders and creditors are both financial stakeholders and providers of capital, and in view of *Sequana*, which confirms limited protection for creditors, additional protection for creditors is justified.

Limited clarity has been provided in ascertaining how directors should act in furtherance of their duty to consider creditor interests.¹¹² Neither statute nor common law has resolved the challenge. Thus, the important corporate governance question, namely, whether directors have the capacity to effectively and objectively preserve creditor interests,

¹⁰⁴*Sequana*, [2022] UKSC 25 at [118].

¹⁰⁵*Id.* at [11].

¹⁰⁶*See supra* Part III.

¹⁰⁷*Sequana*, [2022] UKSC 25 at [205], [207].

¹⁰⁸*See supra* Part IV, Section (a).

¹⁰⁹Andrew Keay, *Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors*, 66 MOD. L. REV. 665, 687–98 (2003).

¹¹⁰LOUISE GULLIFER & JENNIFER PAYNE, *CORPORATE FINANCE LAW: PRINCIPLES AND POLICY* 274 (3d ed. 2020).

¹¹¹*See supra* Part III.

¹¹²Andrew Keay, *Directors Duties and Creditors Interests*, 130 L. Q. REV. 443, 451 (2014) (citing *Liquidator of W. Mercia Safetywear Ltd v. Dodd*, [1988] 4 BCC 30, [33] (Civ) (UK)).

whilst promoting shareholder interests remains an issue. This is arguably because regulations are imperfect tools when used to make directors act in certain ways towards protecting the interests of creditors¹¹³ and other stakeholders,¹¹⁴ especially as the same directors are appointed for the predominant purpose of protecting the interests of shareholders. This dilemma can be eliminated by requiring a designated INED to lead the board in considering and preserving creditor interests when the requirement is triggered.

Although *Sequana* did not explain how directors should act, the judgment identified the point when directors' consideration of creditor interests is triggered, by distinguishing real risk of insolvency from remote risk of insolvency.¹¹⁵ The Court considered several judicial authorities, including *Bilta (UK) Ltd. (in liquidation) v. Nazir*,¹¹⁶ a U.K. Supreme Court decision where Their Lordships, Toulson and Hodges JJSC, in their joint judgment endorsed the decisions of the courts in *West Mercia Safetywear Ltd. (in liquidation) v. Dodd*¹¹⁷ and *Kinsela v. Russell Kinsela Pty Ltd.*¹¹⁸ Their Lordships commented on the creditor interest duty and observed that the fiduciary duties of a director of an insolvent company or a company bordering on insolvency, differ from the duties of a director of a company which can meet its liabilities.¹¹⁹ The U.K. Supreme Court thereby confirmed its previous decision in *Bilta* that, as long as a company is able to meet its liabilities to creditors, creditor-interest duty in the latter part of § 172(3) is not triggered.¹²⁰ This indicates that the particular moment the creditor-interest duty is triggered is determined on a case-by-case basis. Despite the decision of the U.K. Supreme Court, the main problem has not been resolved. The extent to which directors, who are appointed to promote shareholder interests, can simultaneously and objectively preserve creditor interests remains to be seen, especially in view of recurrent corporate failures indicated in the data in *Table 1* above.¹²¹ Since the board is bound to consider creditor interests, and creditor interests are linked to corporate interests, boards should not merely be required to be objective in considering creditor interests, they should be seen to be

¹¹³See John Quinn & Philip Gavin, *The Creditor Duty Post Sequana: Lessons for Legislative Reform*, 23 J. CORP. L. STUD. 271, 292 (2023).

¹¹⁴David Milman & Gary Cook, *Managing Distressed Companies: Adapting to a New Legal Culture*, 28 MANAGERIAL FIN. 34, 35, 43 (2002).

¹¹⁵*Sequana*, [2022] UKSC 25 at [14], [83], [199], [306].

¹¹⁶*Jetivia SA v. Bilta (UK) Limited (in liquidation) and others* [2015] UKSC 23.

¹¹⁷*Dodd*, [1988] BCLC 250 (UK).

¹¹⁸*Kinsela v. Russell Kinsela Pty Ltd. (in liquidation)*, (1986) 4 NSWLR 722 (Austl.).

¹¹⁹*Bilta*, [2015] UKSC 23 at [123].

¹²⁰*Id.*; *Sequana*, [2022] UKSC 25 at [79].

¹²¹Licht, *supra* note 17 at 1753; see *Sequana*, [2022] UKSC 25 at [250]. See also *supra*

manifestly objective in considering and preserving creditor interests in the twilight zone.¹²² Hence, directors that are accustomed to promoting shareholder interests should be excused from this important role, by requiring a designated INED to lead the board in preserving creditor interests when the creditor-interest duty is triggered.

B. Delaware

In the United States, unsecured creditors rank below preferential creditors.¹²³ Priority among unsecured creditors is outlined in the United States Bankruptcy Code¹²⁴ and payments are required to be made on a fractional basis to certain unsecured creditors.¹²⁵ The requirement for fractional payment is not just an indication that certain unsecured creditors may not be paid, just like the *pari passu* principle that applies in the U.K., it also shows the current limitation of regulation in protecting unsecured creditors when a corporation is insolvent, despite their position as joint financial stakeholders with shareholders and secured creditors.¹²⁶

In Delaware, directors' duties are similarly owed to the corporation and exercised for the benefit of shareholders.¹²⁷ In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, the Delaware Court of Chancery observed that "where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."¹²⁸ This was further explained in *Production Resources Group L.L.C. v. NCT Group, Inc* where the court held that the decision in *Credit Lyonnais Bank*, implies that directors would be protected by the business judgment rule¹²⁹ if they act in good faith in pursuing a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.¹³⁰ This indicates the difficult position that directors are confronted with in

¹²²See Companies Act 2006, c. 46, §§ 170, 172 (UK); *Malone*, 722 A.2d at 10; *McMullin*, 765 A.2d at 917; *Harris*, 582 A.2d at 234.

¹²³See, e.g., *Long*, 117 U.S. at 620–21; *Dewsnup*, 502 U.S. at 417; see also *Investor Bulletin: Bankruptcy for a Public Company*, U.S. SEC. & EXCH. COMM'N (Mar. 31, 2015), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-84>.

¹²⁴11 U.S.C. § 507.

¹²⁵See, e.g., *id.* § 507(4)–(8).

¹²⁶See *Gray's Inn Construction*, [1980] 1 WLR 711.

¹²⁷See *Harris*, 582 A.2d at 234–35.

¹²⁸*Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

¹²⁹See *Smith v. Van Gorkom*, 488 A.2d 858, 864 (Del. 1985).

¹³⁰*Prod. Res. Grp. L.L.C. v. NCT Grp., Inc.*, 863 A.2d 774, 788 (Del. Ch. 2004).

attempting to balance the interests of shareholders and creditors who are both financial stakeholders in a corporation.¹³¹

The court in *Production Resources Group*, was not required to explore the contentious "zone of insolvency" argument.¹³² As noted by Vice Chancellor Strine, the court was required to resolve the motion before it, relating to a well-settled principle that directors should take on a fiduciary relationship to the company's creditors when a firm has reached the point of insolvency.¹³³ Vice Chancellor Strine concluded that the court's decision in *Credit Lyonnais Bank*, that directors' duties are owed to the corporate enterprise to maximize the corporation's value and hereby best satisfy the legitimate claims of all its constituents,¹³⁴ has been wrongly construed as requiring directors to owe fiduciary duties to creditors.¹³⁵ The court further held that the expansive interpretations of the decision wrongly indicate that when a corporation is in the zone of insolvency, creditors can challenge directors' business judgments as breach of fiduciary duties owed to them, thereby using the law of fiduciary duty to fill gaps that do not exist.¹³⁶ In other words, *Credit Lyonnais Bank* merely provides directors with a shield from stockholders who claim that the directors had a duty to undertake extreme risk, so long as the company would not technically breach any legal obligations;¹³⁷ it does not confer directors with fiduciary responsibilities to creditors.¹³⁸ Accordingly, the court in *Production Resources Group* dismissed the creditors' claim against directors for breach of fiduciary duties in part, on the basis that the claim failed to plead any fact, apart from conclusory statements regarding the acts of financial mismanagement by the directors.¹³⁹ It was further stated that although creditors may be protected by covenants and other negotiable contractual protections, there are limitations.¹⁴⁰ These limitations have been examined in detail, to indicate that additional protection is imperative.¹⁴¹

The decision of the court in *Credit Lyonnais Bank*¹⁴² and the explanations provided in *Production Resources Group L.L.C.*,¹⁴³ have been

¹³¹*Prod. Res. Grp. L.L.C.*, 863 A.2d at 800.

¹³²*Id.* at 790.

¹³³*Id.* at 798.

¹³⁴See generally *Credit Lyonnais Bank*, 1991 WL 277613.

¹³⁵*Prod. Res. Grp. L.L.C.*, 863 A.2d at 788.

¹³⁶*Id.* at 789–90.

¹³⁷See generally *Credit Lyonnais Bank*, 1991 WL 277613.

¹³⁸*Prod. Res. Grp. L.L.C.*, 863 A.2d at 788–89.

¹³⁹*Id.* at 777, 803.

¹⁴⁰*Id.* at 790.

¹⁴¹See Keay, *supra* note 109.

¹⁴²*Credit Lyonnais Bank*, 1991 WL 277613, at *33–34.

¹⁴³*Prod. Res. Grp. L.L.C.*, 863 A.2d at 787.

clarified further by the Supreme Court of Delaware when it held that fiduciary duties are not owed to creditors, even when a company is on the verge of insolvency.¹⁴⁴ Justice Holland observed in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* that

When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.¹⁴⁵

This makes it abundantly clear that creditor interests can only become the primary focus of directors' duties when a company is insolvent. In Delaware, the requirement to consider creditor interest is not definite.¹⁴⁶ Directors are simply required to act for the benefit of shareholders even when a company is undergoing financial challenges.¹⁴⁷ This is in slight contrast to the applicable regulatory framework in the U.K. that the duty to "consider" creditor interest could be triggered when the company's circumstances fell short of actual insolvency.¹⁴⁸ The Delaware Supreme Court held that, rather than requiring directors to consider creditor interests, companies should be expected to be run by effective leadership that will avoid challenges to creditors if a company becomes insolvent.¹⁴⁹ The Court quoted the Court of Chancery with agreement, that "an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership[.]"¹⁵⁰ The court further held that "so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value[.]"¹⁵¹ "any benefit to be derived by . . . additional directclaims [by creditors] appears minimal, . . . [and would be] significantly outweighed by the costs to economic efficiency."¹⁵² Indeed, if companies have effective and proactive leadership and directors pursue corporate objectives with fidelity and prudence when a company is

¹⁴⁴*Gheewalla*, 930 A.2d at 100–01.

¹⁴⁵*Id.* at 101.

¹⁴⁶*Id.* at 99.

¹⁴⁷*Id.*

¹⁴⁸*Sequana*, [2022] UKSC 25 at [81].

¹⁴⁹*Gheewalla*, 930 A.2d at 100.

¹⁵⁰*Id.* (quoting *N. Am. Cath. Educ. Programming Found. Inc. v. Gheewalla*, No. Civ.A. 1456-N, 2006 WL 2588971, at *13 (Del. Ch. Sep. 1, 2006)).

¹⁵¹*Id.* (quoting *Prod. Res. Grp. L.L.C.*, 863 A.2d at 790).

¹⁵²*Id.* at 100 (quoting *Gheewalla*, 2006 WL 2588971, at *13).

in the zone of insolvency, creditor interests are not likely to be undermined if the company becomes insolvent. The Delaware Supreme Court on this matter has been described as "commensurately certain and convincing" by firmly requiring directors' fiduciary duties to be unchanged even when a corporation borders insolvency.¹⁵³ Even though the positions of the courts in the U.K. and Delaware differ in respect of directors' duties in the zone of insolvency, similar problems exist in both jurisdictions as follows. Creditors are at risk of loss of capital when a corporation becomes insolvent, thus, it is imperative for the board to preserve creditor interests before their interests become paramount if the corporation becomes insolvent.¹⁵⁴ In the absence of legal protection, one of the effects of the decision of the Delaware Supreme Court is that corporate entities should adopt proactive and effective board leadership to protect creditor interests, without restricting directors' discretion to promote corporate and shareholder interests. Another effect of the *Gheewalla* decision is that directors would not likely be held liable for breach of their fiduciary duties for risky decisions made for the purpose of maximizing the value of corporations, regardless of whether those decisions undermined creditors and caused the corporation to become insolvent.¹⁵⁵ This was the Delaware Court of Chancery's decision in *Quadrant Structured Products Co. Ltd. v. Vertin*,¹⁵⁶ where creditors instituted a derivative claim against the board of directors for its decision to permit certain riskier and more speculative investments rather than adopting a more conservative strategy in preparation for insolvency. The court rejected the claim, and held that the "[d]irectors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors."¹⁵⁷ This decision followed the *Gheewalla* holding that "directors must continue to discharge their duties for the interest of the corporation and its shareholders" even though a corporation is navigating in the zone of insolvency.¹⁵⁸ The risk of insolvency, which may occur as a result of poor decisions made by directors when the company is in the zone of insolvency is thereby passed to creditors.

Recurrent corporate failures show that there are practical challenges in enforcing directors' duties to promote the corporate interest for the

¹⁵³Farqaleet Khokhar, *When Do Directors' Duties Shift to Protect Creditors' Interests?*, 48 DEL. J. CORP. L. 95, 98–99 (2024).

¹⁵⁴*Prod. Res. Grp. L.L.C.*, 863 A.2d at 791.

¹⁵⁵See *Gheewalla*, 930 A.2d at 100.

¹⁵⁶*Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 535, 541 (Del. Ch. 2015).

¹⁵⁷*Id.* at 547.

¹⁵⁸*Gheewalla*, 930 A.2d at 99.

benefit of shareholders, whilst merely considering creditor interests, especially when a company is experiencing financial challenges.¹⁵⁹ The kind of board leadership that may likely pursue corporate objectives with fidelity and prudence is the type that is provided by a designated INED, who, unlike executive directors, has not been previously saddled with the day-to-day responsibility of promoting shareholder interest. To achieve the ideal leadership role that is characterised by fidelity and prudence, as contemplated by the Delaware Supreme Court, the requirement that directors should preserve creditor interests when a company enters the zone of insolvency should be emphasised in Delaware. This would ensure that while directors continue to take calculated economic risks for the benefit of their shareholders when a company is in the zone of insolvency. A designated INED would ensure that such risks would not undermine creditor interests or lead to the demise of the corporation. The role of the designated INED is examined next.

V. PRESERVING CREDITOR INTERESTS

The challenges caused by ineffective boards in preventing corporate failures largely influenced the development of corporate governance regulation in the United Kingdom¹⁶⁰ and the United States.¹⁶¹ Despite the challenges of ineffective boards, boards have nevertheless remained the custodians and enforcers of corporate regulation. For example, the "comply or explain" approach to corporate governance regulation in the United Kingdom requires boards to determine which corporate governance principles they wish to comply with, and provide reasons when there has been non-compliance.¹⁶² In Delaware, where compliance is mandatory, following the nationwide application of the *Sarbanes Oxley Act*, designated senior board members are required to certify the accuracy of financial statements of their companies as part of the compliance measures with corporate governance regulation.¹⁶³ They are to confirm that

¹⁵⁹See *supra* Table 1.

¹⁶⁰See FINANCIAL REPORTING COUNCIL, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (Dec. 1992), https://media.frc.org.uk/documents/Cadbury_Code_-_The_Financial_Aspects_of_Corporate_Governance.pdf; Paul George, *The UK's Independent Regulator for Corporate Governance and Reporting*, FIN. REPORTING COUNCIL, https://assets.publishing.service.gov.uk/media/5329db50e5274a2268000045/financial_reporting_council_presentation.pdf (last visited May 11, 2023).

¹⁶¹As a response to corporate scandals in the U.S., including the Enron Corporation scandal, the Sarbanes-Oxley Act of 2002 was established. See generally Pub. L. No. 107-204, 116 Stat. 745 (2002); see also, Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(m)(3).

¹⁶²See FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE 2-3 (2018), https://media.frc.org.uk/documents/UK_Corporate_Governance_Code_2018.pdf.

¹⁶³Sarbanes-Oxley Act § 302.

they have reviewed the company's financial report and that the report does not contain any untrue statement of facts or omission, thereby indicating their responsibility for establishing and maintaining internal controls.¹⁶⁴ Both the U.K. and U.S. approaches recognise the importance of an effective board towards preventing corporate failures that could lead to insolvency. If creditor interests are not preserved when an entity is solvent, their interests may not be capable of being protected when the entity is insolvent and those creditors' interests have become paramount.¹⁶⁵

The decision to engage in a risky project that could enhance returns for shareholders and potentially undermine the interests of creditors remains the directors' dilemma. Although the U.K. Supreme Court has delivered its judgment in *Sequana*,¹⁶⁶ the dictum of David Richards LJ of the Court of Appeal, there,¹⁶⁷ clearly portrays the directors' dilemma in considering creditor interests while promoting the interests of shareholders. His Lordship observed:

. . . The reconciliation of the duty under section 172(1) and the creditors' interests' duty will, unless creditors' interests are paramount, present difficulties. Take the case of a company which is solvent and has cash resources available to meet a liability due to mature in two years' time. The interests of creditors would be served by retaining the cash until the liability matures, investing it in the meantime in risk-free assets. The company has an opportunity to invest the funds in a business venture that carries significant risks and rewards. It would not be a foolhardy investment but, if the real risk of failure occurs, it is the creditors who will lose.¹⁶⁸

This further reflects the decision of the Delaware Court of Chancery in *Quadrant*,¹⁶⁹ examined above, following the decision of the Delaware Supreme Court in *Gheewalla*.¹⁷⁰

In the U.K., directors may be held liable for failing to consider the interests of creditors. For example, in an action for declaratory relief in

¹⁶⁴See BOB TRICKER, CORPORATE GOVERNANCE: PRINCIPLES, POLICIES AND PRACTICES 129 (4th ed. 2019).

¹⁶⁵See *Sequana*, [2022] UKSC 25; *Colin Gwyer & Assoc. Ltd.*, [2003] BCC 885 (UK); *Re Oxford Pharm. Ltd.* [2009] EWHC 1753 (Ch) (UK); *Roberts*, [2011] EWHC 257 (Ch) (UK); *Re HLC Env't Projects Ltd.* [2013] EWHC 2876 (Ch) (UK).

¹⁶⁶*Sequana*, [2022] UKSC 25.

¹⁶⁷*BTI 2014 LLC v. Sequana SA* [2019] EWCA 112 (Civ).

¹⁶⁸*Id.* at [199].

¹⁶⁹*Vertin*, 115 A.3d at 549.

¹⁷⁰*Gheewalla*, 930 A.2d at 99.

relation to an apparently insolvent company, the court held that directors failed to consider the interests of the company's creditors when they voted in favour of a resolution at a board meeting which undermined the ability of creditors to recover the sums due to them from the company.¹⁷¹ Similarly, in *HLC Environmental Projects Ltd, Re*¹⁷² the liquidators of an insolvent company succeeded in a claim against the directors for failing to consider the interests of creditors.¹⁷³ These and other cases where directors were held to have breached their duty to consider creditor interests were instituted by liquidators or the relevant insolvency practitioner when the companies were insolvent.¹⁷⁴ This indicates that the objective of *considering creditor interests* may not necessarily be aimed at preventing creditor interests from being undermined, since creditor interests can only be enforced at insolvency, with the risk that unsecured creditors' losses may not be remedied. In view of continuous corporate failures, the objective should be to prevent circumstances where creditor interests may be undermined by requiring the board to preserve creditor interests while promoting shareholder interests.¹⁷⁵

In Delaware, the decision of the Delaware Supreme Court in *Gheewalla*, that the focus of the board of directors does not change even when a solvent corporation is navigating in the zone of insolvency,¹⁷⁶ makes it unlikely for directors to be held liable for failing to consider creditor interests. This applies in the absence of fraudulent conduct and if it can be shown that the affected directors duly exercised business judgment.¹⁷⁷ Therefore, the requirement that directors should consider and preserve creditor interests when a company enters the zone of insolvency should be emphasised in Delaware, since it is only in exceptional cases that personal action can be instituted against directors for their conduct, for example, if they pay unlawful dividends.¹⁷⁸ Even though directors are required to contribute to the liabilities of companies, it is not clear whether the contributions made by directors would be sufficient to meet the liabilities due to unsecured creditors. Thus, a mechanism that can prevent directors from failing to preserve the interests of creditors is desirable.

¹⁷¹*Colin Gwyer & Assoc. Ltd.*, [2003] BCC 885 at [5].

¹⁷²See generally *Re HLC Env't Projects Ltd.* [2013] EWHC 2876 (Ch).

¹⁷³*Id.* at [129]–[131], [133].

¹⁷⁴See *Re Micra Contracts Ltd. (in Liquidation)* [2016] B.C.C. 153 (Ch) [100]–[107]; *Roberts*, [2011] EWHC 257 (Ch) at [240]–[244]; *IRC v Richmond and Jones (Re Loquitur Ltd.)* [2003] EWHC 999 (Ch). But see *Colin Gwyer & Assoc. Ltd.*, [2003] B.C.C. 885 (demonstrating a case where the shareholders sought a declarative relief when the company was apparently insolvent.).

¹⁷⁵See *Sequana*, [2022] UKSC 25; *Gheewalla*, 930 A.2d.

¹⁷⁶*Gheewalla*, 930 A.2d at 101.

¹⁷⁷*Id.*

¹⁷⁸DEL. CODE ANN. tit. 8, §§ 170, 174.

It has been rightly suggested that directors should focus on promoting the corporate interests by maximizing the wealth of the corporation as an entity, to avoid the difficulty of trying to balance the interests of shareholders and creditors.¹⁷⁹ This difficulty is undesirable. As further suggested, creditors are vulnerable and directors can act as they choose, even though they are acting with creditors' money.¹⁸⁰ To address directors' dilemma and uncertainties¹⁸¹ that tilt towards the interests of shareholders, a designated INED, acting as a senior independent non-executive director, can lead the objective of preserving the interests of creditors when a corporate entity encounters serious financial challenges.

The INED can be appointed to make decisions with a committee, to determine the extent to which creditor interests have been satisfactorily considered. A company's set gearing ratio can be used to determine when the appointment of the INED would be triggered. Ideally, the appointment can be triggered when the company's debt level reaches a certain threshold, requiring the board to objectively consider whether the company should invest in further risky ventures that could either increase earnings or threaten the corporate existence.¹⁸² The powers of the INED and the committee would cease as soon as the threshold is successfully lowered.

It is not expected that the designated INED and the committee will operate without challenges. For example, the INED may lack sufficient information about the company that would enable them to thoroughly assess the report of the executive management and the impact of a risky project on the corporate interest.¹⁸³ Consequently, and undesirably, the INED would have to rely on the information provided by the company's executive management.¹⁸⁴ Apart from the issue of information asymmetry, the limited time that INEDs spend in their supervisory roles¹⁸⁵ may undermine their capacity to effectively engage with and challenge management in preserving creditor interests. Particularly, the INED may not be as experienced as the executive management team to ascertain the impact of a risky project on creditor interests, since the executive management team may have dealt with similar projects from previous

¹⁷⁹Keay, *supra* note 112 at 471.

¹⁸⁰*Id.* at 679.

¹⁸¹See Aurelio Gurrea-Martinez, *Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach*, 21 J. CORP. L. STUD. 365, 379–81 (2021).

¹⁸²*See id.*

¹⁸³See Jonathan Liu & Tomas Andersson, *Mind the Gap: Expectations on the Role of UK Non-Executive Directors* 3–4 (Regent's Working Papers in Bus. & Mgmt., Working Paper No. 1402, 2014).

¹⁸⁴*See id.* at 4.

¹⁸⁵*See id.*

experiences.¹⁸⁶ These challenges can be addressed by an executive report, to enlighten and convince the INED about the viability of any risky project, including the views of experienced non-executive directors on the board.¹⁸⁷ Further, the role of the INED may trigger subtle resistance from the executive management team. They may consider the role of the INED as second-guessing their decisions and consequently challenging their expertise.¹⁸⁸ In addition, the role of the INED may lead to delay in decision making, especially where the board needs to consider an urgent risky project.¹⁸⁹ Considerable time could lapse between when the board prepares its report about the viability of the project and the ways that the company would absorb the risks, and the time when the INED and the committee would have reviewed the report and meet the board to determine the best decision to take collectively. Most of these challenges are currently experienced by non-executive directors; nevertheless, the challenges have not deterred NEDs in their monitoring roles. Particularly, the need to ensure that creditor interests are preserved should take priority over speedy commencement of a project, since the interests of creditors are linked to the survival of the corporation.

The ways in which the INED implements its role may determine the extent to which the board and executives collaborate. It has been suggested that it is the actual conduct of the non-executive *vis-à-vis* the executive that determines board effectiveness; that non-executive directors should engage with executives to learn more about the company, challenge executives in their day-to-day roles and be equally supportive of executives to help them promote corporate objectives.¹⁹⁰ Thus, the role of the INED is not aimed at substituting or "second-guessing" the duties of the board and executive management, but rather at aiding the board to perform its duties objectively.¹⁹¹ This can be achieved by ensuring regular communication about the role of the INED between the INED, the committee, and the board.

The role of the INED would generally be a preventive measure and an incentive for directors to develop effective internal controls that would keep the debt levels of the corporation below the set threshold, thereby

¹⁸⁶See Lui & Andersson, *supra* note 184, at 4.

¹⁸⁷See Christopher Pass, *Corporate Governance and the Role of Non-Executive Directors in Large UK Companies: An Empirical Study*, 4 CORP. GOVERNANCE 52, 59 (2004).

¹⁸⁸See *id.* at 52–53.

¹⁸⁹See *id.* at 59.

¹⁹⁰John Roberts, Terry McNulty & Philip Styles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 BRIT. J. MGMT. 5, 13–15 (2005).

¹⁹¹*Id.* at 13–14.

ensuring that the need to appoint an INED is never triggered.¹⁹² This role is not radically different from what INEDs are currently required to do; it merely expands the scope of the duty of INEDs in engaging with executives. To address the view that directors could be risk averse when their companies are undergoing financial difficulties,¹⁹³ the board and the INED can weigh the risk of embarking on a risky project, and their final decision would be determined by the prospects of either economic gains or insolvent liquidation.

VI. CONCLUSION

When a corporation is operating in the zone of insolvency, it is economically reasonable to adopt a conservative approach to investment decisions, in order to preserve the corporation for the interests of shareholders, creditors and other stakeholders.¹⁹⁴ In view of shareholders' dominant influence over directors, directors of financially challenged entities may be inclined to engage in risky investment projects, with the hope of obtaining economic gains for their shareholders, despite the potential risks to the corporation. This dynamic exposes creditors to avoidable risks.¹⁹⁵ Since corporate capital consists of equity and debt, shareholders and creditors are financial stakeholders in corporate entities, and directors' duties are generally exercised in the interests of shareholders and creditors,¹⁹⁶ in view of their claims to equitable interest and property rights in the corporation.¹⁹⁷ The duties are not exercised in the interest of any other corporate constituents at any time.¹⁹⁸ Hence it is justifiable to protect the interests of creditors when a corporation is in the zone of insolvency.¹⁹⁹ Consequently, in view of persistent corporate failures and losses to creditors, this article examined the capacity of directors to effectively and objectively preserve the interests of creditors whilst promoting shareholder interests, when a corporation is undergoing financial challenges.²⁰⁰ It argued that the inability of directors to preserve creditor interests when a corporation is in the zone of insolvency is a result

¹⁹²See Roberts, McNulty & Styles, *supra* note 190, at 14.

¹⁹³Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 787 (1993).

¹⁹⁴*Id.* at 683–84.

¹⁹⁵*Id.*

¹⁹⁶Gans v. MDR Liquidating Corp., CIV. A. No. 9630, 1990 WL 2851, at *9 (Del. Ch. Jan. 10, 1990).

¹⁹⁷Alan W. Tompkins, *Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception*, 47 SMU L. REV. 165, 169 (1994).

¹⁹⁸*Id.*

¹⁹⁹See LoPucki & Whitford, *supra* note 193, at 787.

²⁰⁰See *supra* Part III.

of the shareholder approach to corporate regulation.²⁰¹ The inability of the board to ensure that creditor interests are not disregarded has the potential to undermine the interests of creditors before they become paramount at insolvency.

The framework for corporate regulation in the U.K. and Delaware requires that directors' duties are owed to the corporation for the benefit of shareholders.²⁰² The analyses presented in this article show that directors' affiliations to shareholders can limit their capacity to preserve creditor interests.²⁰³ In both jurisdictions, there is limited scope for directors to protect creditor interests when a corporation is experiencing financial challenges; directors' duties are still to be exercised in the interest of shareholders during such financial difficulties.²⁰⁴ While it has been argued in this article that it is desirable to enhance the scope of protection available to creditors as financial stakeholders, it is not suggested that directors' duties should be owed to creditors or exercised directly in the interest of creditors pre-insolvency. The interests of creditors, especially unsecured creditors, can be protected by ensuring that, when the corporation operates in the zone of insolvency, a designated INED is tasked with ascertaining whether creditor interests have been effectively preserved before risky investment decisions are made.²⁰⁵ This is unlikely to undermine the interests of shareholders since the role of the INED would invariably be aimed at helping the board preserve the corporation.

While a risky project may generate significant gains for shareholders, it may also lead to the demise of the corporation. Thus, sacrificing such project when a corporation is in the zone of insolvency would ensure that the corporation is not insolvent, and shareholders will retain the opportunity to earn future returns from the corporation. The article further demonstrates the justification for the role of the designated INED in view of the limited extent to which directors may be held liable for losses to creditors when a corporation becomes insolvent.²⁰⁶ This is indicated in the analyses of the Supreme Court decisions.²⁰⁷ Even though directors are held personally liable for acting in ways that undermine creditor interests pre-insolvency, before creditor interests become paramount, they may not be able to meet their company's liabilities to every unsecured creditor if they are personally held liable for breach of

²⁰¹See *supra* Part III.

²⁰²See *supra* Part III.

²⁰³See *supra* Part III.

²⁰⁴See *supra* Part IV for analysis of the decisions of the Supreme Courts.

²⁰⁵See *supra* Part III.

²⁰⁶See *supra* Part V.

²⁰⁷See *supra* Part IV.

duty. Thus, a preventive approach would achieve a better result. The role of the INED would serve as a mechanism to prevent directors from disregarding creditor interests, rather than seeking an unavailable remedy when the corporation is insolvent.