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Corporate Failures and Directors' Duties: Towards a Paradigm of Financial Stakeholding

Corporate Failure and Directors' Duties: Towards a Paradigm of Financial Stakeholding

Abstract

By reference to the financial stakeholding analytical framework, this article challenges the capacity of directors to ensure that creditor interest is 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. The 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, it suggests that a designated independent non-executive director INED 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*

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 of directors are stated to be 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 UK, which are similarly aimed at promoting shareholder interest.[4] Further, while board effectiveness is considered as an essential requirement for the sustainability of corporate entities,[5] the role of non-executive directors NEDs, that significantly contributes to board effectiveness[6] appears to steer the objectives of board effectiveness towards promoting shareholder interests. For example, NEDs are appointed to promote board effectiveness and objectivity towards ensuring that the corporation promotes value for shareholders.[7] These indicate that the interest of shareholders invariably shapes the role of boards, and the combined effects of corporate law and corporate governance regulations mainly promote shareholder interests.

Recently, the UK Supreme Court in *BTI 2014 LLC v Sequana,*[8] held that it is liquidation rather than insolvency or the risk of insolvency that converts creditors into the main stakeholders in the company.[9] The apex court held that when a company is undergoing financial difficulties,

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[1] *Companies Act 2006,* ss 171-177; *Malone v Brincat*, 722 A.2d 5, 10 (Del. 1998); *McMullin v Beran*, 765 A.2d 910, 917 (Del. 2000).
[2] *Companies Act 2006*, s 170(1); *Harris v Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).
[3] *Companies Act, 2006*, s 172(1); *Harris v Carter*, (supra).
[4] See *Corporate Governance Code, 2018*, pages 2-4 'Reporting on the Code' and 'Board Leadership and Company Purpose'.
[5] FRC Guidance on Board Effectiveness, 2018 https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-guidance-on-board-effectiveness-final.pdf accessed December 2023; John F Olson and Michael T Adams, 'Composing a Balanced and Effective Board to Meet New Governance Mandates' 59 *The Business Lawyer* 421, 448-451, (2004).
[6] Andrew Kakabadse, Keith Ward, Nada Korac-Kakabadse & Cliff Bowman, 'Role and Contribution of Non-Executive Directors' 1 *Corporate Governance*, 4, 6-7 (2001); Thomas Clark, 'The Contribution of Non-Executive Directors to The Effectiveness of Corporate Governance' 3 *Career Development International* 118, 119-121 (1998).
[7] *Corporate Governance Code*, *2018*, Principle A. See also 'Reporting on the Code', page 2.
[8] *BTI 2014 LLC v Sequana* [2022] UKSC 25.
[9] *Id*, Lord Briggs, delivering the majority judgement – see paragraphs [165], [199], [202] and [306].

before liquidation becomes inevitable, the creditor duty is the duty of directors to consider creditors' interests, to give them appropriate weight, and to balance them against shareholders' interests where they may conflict.[10] The court acknowledged that while undergoing such financial difficulty, the economic interest of company's creditors would 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.[11] This implies that directors are to merely consider the interests of creditors and balance the interests of both financial stakeholders as required by statute,[12] while promoting the corporate objective for shareholder interests.

In Delaware, directors consider creditor interests to the extent of avoiding personal liability for their conduct, such as paying unlawful dividend[13] when the company was on the verge of insolvency, if the company eventually becomes insolvent. In *North American Catholic Educational Programming Foundation, Inc v Gheewalla,*[14] 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.[15] 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.[16]

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 when they exercise business judgment would enable them to balance the competing interests

[10] *Id*, [176].
[11] *Id*, [83].
[12] *Companies Act* 2006, s 172(3).
[13] *Delaware General Corporation Law*, §§ 170, 174.
[14] *North American Catholic Educational Programming Foundation, Inc v Gheewalla* 930 A.2d 92, 99 (Del. 2007), 101.
[15] *Id.*
[16] *Id*.

of shareholders and creditors.[17] Alternatively, it has been argued that a custodial duty of caution should replace directors' entrepreneurial duty[18] when an entity is in the zone of insolvency. However, the extent to which directors can effectively and objectively exercise business judgement or replace their entrepreneurial duty with custodial duty of caution when a corporation struggles financially is doubtful. Directors are accustomed to promoting shareholder interest; hence directors lack the capacity to be objective in balancing shareholders and creditors interests. 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 will potentially further encourage directors and shareholders to reject external interferences[21] outside the board that attempt to tame shareholder and directors' entrepreneurial objectives while in the zone of insolvency. The article therefore suggests that a designated INED should be required to determine the extent to which creditor interests are preserved when directors make decisions in the zone of insolvency. This 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, to particularly 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 stakeholders[22] and contributors of the capital of corporations. Secondly,

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[17] Philip Gavin, 'A Rejection of Absolutist Duties as a Barrier to Creditor Protection: Facilitating Directorial Decisiveness Surrounding Insolvency through the Business Judgment Rule' 15 *Brooklyn Journal of Corporate, Financial & Commercial Law* 313-358 (2021).
[18] Amir N. Licht, 'My Creditor's Keeper: Escalation of Commitment and Custodial Fiduciary Duties in the Vicinity of Insolvency' 98 *Wash U L Rev* 1731, 1749-1753 (2021).
[19] See Table 1 below.
[20] See the explanations in section II below. See also 'Andrew Keay, Formulating a Framework for Directors' Duties to Creditors: An Entity Maximisation Approach' 64 *The Cambridge Law Journal* 614, 626 (2005).
[21] Footnote 18 above, 1753.
[22] Shareholders and creditors have been described as financial stakeholders in a corporation, or important stakeholders in the company's assets, since they particularly invest financial resources in corporations, unlike

failure to promote shareholder short term interests would not likely lead to the demise of the corporation, unlike failing to preserve creditor interest which 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 under control, namely, 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 rest of the paper is presented as follows. The methodology section is presented next. It highlights the justifications for the comparative study, with data indicating the continuous increase in corporate failures in the UK and the US. After the methodology section, the position of shareholders and creditors as financial stakeholders of the corporation is outlined. This includes an analysis of the effects of the dominant influence of shareholders over the corporation. Then, the limitations of directors' duties in preserving the interests of creditors before they become paramount at insolvency are examined. Before the concluding section, the problem of corporate failures is argued to be manifested in the performance of directors' duties when creditor interest is undermined.

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other stakeholders. See generally, Niamh M. Brennan and Doris M. Merkl-Davies, 'Do Firms Effectively Communicate with Financial Stakeholders? A Conceptual Model of Corporate Communication in a Capital Market Context' (2018), 48 *Accounting and Business Research*, 553-577; Jacob S. Ziegel, 'Creditors as Corporate Stakeholders: The Quiet Revolution, An Anglo-Canadian Perspective' (1993) 43 *University of Toronto Law Journal* 511-531.

Methodology

A review of corporate insolvencies among G20 countries indicate that the UK and the US account for the highest number of corporate insolvencies as of April 2020.[23] This was the period immediately before the Covid 19 Pandemic. Hence, corporate insolvencies during this period were not likely influenced by the pandemic, unlike insolvencies that occurred during and after the pandemic. The G20 countries represent the most industrialised countries worldwide. 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 worldwide. For example, the G20 make up about 85% of the world economy and about three-quarters of global trade.[24] Table 1 below from *Trading Economics* New York, shows a list of insolvencies in G20 countries. It shows different reference periods for countries in the table. The earliest period of corporate insolvency is reported as June 2019 for Italy. The latest corporate insolvencies were reported in April 2020 for Japan, Netherlands, Singapore, and South Korea. The highest figure of 13,840 insolvencies is reported for Switzerland, however, this figure includes individual and corporate insolvencies. The United States and the United Kingdom were identified as the countries with the highest corporate insolvencies, with the figures of 23,114 and 3,883 respectively, reported in March 2020.

In the US, while federal laws apply partly to regulate companies, states also regulate companies, especially directors' duties. It is beyond the scope of the study to examine corporate regulation relating to directors' duties across all the states in the US. Delaware was therefore considered and compared with the UK for the following reasons.

[23] See Table 1 below. Trading Economics 'Bankruptcies Reported in G20 Countries- https://tradingeconomics.com/country-list/bankruptcies?continent=g20 accessed 15 September 2020. Cited with permission from Trading Economics, New York.

[24] Rosamond Hutt, 'What You Need to Know About the G20' 2 September 2016, *World Economic Forum* https://www.weforum.org/agenda/2016/09/what-you-need-to-know-about-the-g20/ accessed 20 November 2022; Congressional Research Service Report, 'The G-20 and International Economic Cooperation: Background and Implications for Congress' (October 2019) https://fas.org/sgp/crs/row/R40977.pdf accessed 21 May 2022.

Unlike other states, the State of Delaware is home to 68% of Fortune 500 companies and 93% of all U.S.-based initial public offerings (public companies).[25] Delaware offers immense corporate tax benefits and it's Court of Chancery is widely recognised in resolving corporate disputes. These make Delaware to be an attractive state and a prime choice for corporate registration in the United States. Even though directors in both the UK and Delaware owe their duties to their companies, directors' duties are exercised for shareholder interests in both jurisdictions. Essentially, both the UK and Delaware require directors to promote shareholder interests.

In the UK and Delaware, directors' duties remain owed to shareholders even though a company is undergoing financial challenges. The Supreme Courts in the UK and Delaware have held accordingly. In the UK and US broadly, Delaware inclusive, unsecured creditors are likely to recover little or nothing from insolvent companies. Their claims usually rank lower than the claims of other creditors. The *pari passu* principle that applies in the UK seeks to ensure that unsecured creditors share rateably in the assets of the insolvent company that are available for residual distribution.[26] 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 to be made on the basis of the *pari passu* principle. Similarly, in the US, Delaware inclusive, unsecured creditors rank below preferential creditors.[27] Priority among unsecured creditors is outlined in statute;[28] payments are required to be made on a fractional basis to certain unsecured creditors.[29] The requirement

[25] Chauncey Crail, Rob Watts and Jane Haskins, 'Why Incorporate in Delaware? Benefits and Considerations' *Forbes* 14 December, 2021 https://www.forbes.com/advisor/business/incorporating-in-delaware/#:~:text=The%20most%20famous%20reason%20Delaware,not%20pay%20corporate%20income%20tax accessed 12 July 2022.

[26] *Re Gray's Inn Construction Ltd* [1980] 1 WLR 711.

[27] *Long v Bullard,* 117 U.S. 617 (1886); *Dewsnup v Timm,* 502 U.S. 510 (1992); US Securities and Exchange Commission, 'Bankruptcy: What Happens When Public Companies Go Bankrupt?' February 3 2009 https://www.sec.gov/reportspubs/investor-publications/investorpubsbankrupthtm.html accessed 6 August 2021.

[28] *The United States Bankruptcy Code* § 507.

[29] *Id*, § 507(4).

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 UK, it also shows the limitation of regulation in protecting unsecured creditors at insolvency, despite their position as joint financial stakeholders with shareholders and secured creditors.

The level of insolvencies in the UK and the US 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 interest. 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 encourage directors to engage in risks that may ultimately undermine creditor interests and the overriding corporate interests.

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

Country	Last	Previous	Reference	Unit
Australia	683	667	Mar/20	Companies
Canada	175	233	Mar/20	Companies
France	268	282	Dec/19	Companies
Germany	1529	1609	Feb/20	Companies
Italy	2844	2823	Jun/19	Companies
Japan	743	740	Apr/20	Companies
Netherlands	395	361	Apr/20	Companies
Russia	2538	3145	Mar/20	Companies
Singapore	22	91	Apr/20	Companies

Country	Last	Previous	Reference	Unit
South Africa	164	125	Feb/20	Companies
South Korea	24	28	Apr/20	Companies
Spain	1501	1979	Mar/20	Companies
Switzerland	13840	13971	Dec/19	Companies and Individuals
Turkey	821	865	Mar/20	Companies
United Kingdom	3883	4284	Mar/20	Companies
United States	23114	22780	Mar/20	Companies

Source – *Trading Economics*[30]

Table 1 *above shows a list of corporate insolvencies among G20 countries as of April 2020. It shows that the US and the UK account for the highest number of corporate insolvencies among the most industrialized countries worldwide. Switzerland shows the overall highest number of combined figures for individual and corporate insolvencies.*

[30] Trading Economics 'Bankruptcies Reported in G20 Countries https://tradingeconomics.com/country-list/bankruptcies?continent=g20 accessed 15 September 2020. Cited with permission from Trading Economics, New York.

II. Financial Stakeholding and the Corporate Interest

Although directors' duties are stated to be owed to the company, the duty to promote the success of the company is required to be exercised for the ultimate benefit of members of the company.[31] Directors in the UK are nevertheless required to consider the likely consequences of any decision in the long-term and they are also required to consider the interests of other stakeholders, namely, creditors, employees, the community, suppliers, among others.[32] However, in view of the dominant influence of shareholders over the role of directors, they are constrained to mainly focus on promoting shareholder interests. For example, in the UK and Delaware, shareholders retain powers to appoint and remove directors at any time,[33] irrespective of the duration of directors' employment contract. Other areas of shareholder dominance include the power to amend the company's articles of association or by-laws;[34] the requirement for the approval of certain transactions by shareholders, such as substantial property transactions of the company,[35] loans and quasi loans to directors,[36] and directors' service contract longer than two years.[37] These clearly indicate that the approach of mainstream corporate law does not create any doubt that the interest of shareholders is paramount in the objectives of a corporation. Meanwhile, after incorporation, creditors provide debt capital to finance the business of corporate entities. Creditors are interested in the long-term success of corporate entities since long-term corporate success enhance the chance of creditors in recovering their debt capital. Companies become insolvent either because of their inability to meet their debt obligations when due or demanded by creditors, or when liabilities exceed

[31] *Companies Act 2006*, ss 170, 172; *Malone v Brincat*, 722 A.2d 5, 10 (Del. 1998); *McMullin v Beran*, 765 A.2d 910, 917 (Del. 2000); *Harris v Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).
[32] *Companies Act 2006*, s 172) (1) (a)-(f).
[33] *Companies Act 2006*, s 168; *Delaware General Corporation Law* § 141 (b) & (k).
[34] *Companies Act 2006*, s 21; *Delaware General Corporation Law* § 109.
[35] *Companies Act 2006*, ss 190 & 191; *Delaware General Corporation Law* §144 and 145.
[36] *Companies Act 2006* ss 197, 198.
[37] *Id* s 188.

assets.[38] Although the corporate interest may be rightly equated to both shareholder and creditor interests when the corporation is solvent or insolvent respectively,[39] the desire of creditors for the corporation to remain solvent for the long-term and perhaps indefinitely, so that it can meet it's debt obligations to creditors, indicate a stronger bond between creditor interest and the long term corporate interest as a going concern. Despite the extensive framework of corporate regulations, corporate failures persist.[40] While shareholders may suffer limited losses from corporate failures, in view of the doctrine of separate legal personality, the extent to which creditors are protected from losses is largely unclear, especially unsecured creditors.

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 non-executive directors are constrained to act according to the regulatory approach that promotes shareholder interest.[41] Particularly, shareholder active engagement with boards to address the problems of agency conflict may further influence the supervisory role of the board towards promoting shareholder interest. It has been suggested that greater shareholder protection and power is associated with higher economic growth,[42] nevertheless, it is necessary to ensure that shareholder dominance does not invariably undermine the interests of other stakeholders,[43] when a conflict of interest arises. This appears to have been attempted through the enlightened shareholder value ESV approach in the UK.[44] However, the ESV merely

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[38] *Insolvency Act 1986*, s 123; *The United States Bankruptcy Code* s 101(32); John Birds *et al*, *Boyle & Birds Company Law* (Jordan Publishing, Bristol 2009, 813 (2009).

[39] Andrew Keay and 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 Law World Review* 107, 123 (2024).

[40] See data in the methodology section above.

[41] *Companies Act 2006*, s 172(1); *Harris v Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).

[42] George W Dent, 'The Essential Unity of Shareholders and the Myth of Investor Short-Termism' 35 *Delaware Journal of Corporate Law* 97, 141-149 (2010).

[43] Edward R Freeman, Andrew C Wicks and Bidhan Parmar, 'Stakeholder Theory and The Corporate Objective Revisited' 15 *Organization Science*, 364, 365 – 366 (2004).

[44] *Companies Act 2006*, s 172(1).

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. Thus, it was rightly argued that it is unlikely that the ESV will make any considerable difference in fostering long-term corporate interests.[45] 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 sufficient voice in decision-making.[46] This reflects the argument that the interests of stakeholders with long-term corporate objectives may not necessarily undermine the interest of stakeholders with short-term objectives. The long-term objectives may delay the actualisation of short-term objectives without necessarily preventing the actualisation of the short-term objectives. Whereas short-term objectives may truncate the actualisation of the objectives of long-term corporate stakeholders. Conflict of interests 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. 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 shareholder approach to corporate regulation and administration. The limitations of directors in preserving creditor interest before creditors interests become paramount at insolvency are examined next, particularly in relation to the UK and Delaware. The analyses justify the need to strengthen the board in preserving creditor interest before they become paramount at insolvency.

[45] Andrew Keay, 'Risk, Shareholder Pressure and Short-Termism in Financial Institutions: Does Enlightened Shareholder Value Offer A Panacea?' 5 *Law and Financial Markets Review*, 435, 443 (2011).
[46] Gregory Jackson and Anastasia Petraki, 'How Does Corporate Governance Leads to Short-Termism?' in Sigurt Vitols and Norbert Kluge (eds), *The Sustainable Company: A New Approach to Corporate Governance* vol 1. (European Trade Union Institute ETUI Brussels 218 2011).

III. 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 creditors,[47] and they are not quite protected by the applicable *pari passu* principle.[48] The *pari passu* principle seeks to ensure that unsecured creditors share rateably in the assets of the insolvent company that are available for residual distribution.[49] 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. Since corporate insolvency refers to the inability of a corporate entity to meet its debt obligations, or where liability exceeds its assets,[50] the interest of unsecured creditors is 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 interest.[51] Directors are also required to be mindful of regulations that seek to particularly protect the interests of creditors in certain circumstances.[52] For example, when a company is insolvent, the requirement that directors should '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.[53] However, the former requirement of s 172(3) requiring directors to 'consider' the interests of creditors applies

[47] *Insolvency Act 1986*, ss 107, 115, 143, 156, 175.
[48] Vanessa Finch and David Milman, *Corporate Insolvency Law: Perspectives and Principles* 511-535 (3rd Edn Cambridge University Press, 2017).
[49] *Re Gray's Inn Construction Ltd* [1980] 1 WLR 711.
[50] *The United States Bankruptcy Code* section 101(32); *Insolvency Act 1986*, s 123; John Birds *et al*, *Boyle & Birds Company Law* (Jordan Publishing, Bristol 813 2009).
[51] *Companies Act, 2006* s 172(3).
[52] *Id.*
[53] *Companies Act, 2006* s 172 (1).

mainly in relation to fraudulent trading[54] and wrongful trading[55] provisions under the *Insolvency Act 1986*, to the effect that 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.[56] The main challenge emerges pre insolvency, i.e., when a corporation encounters serious financial difficulties, but it is not yet insolvent; shareholder interest remains paramount, and directors are merely required to consider the interest of creditors. Since shareholder interest remains paramount and directors are merely required to consider creditor interests, the extent to which directors that are required to promote shareholder interests can objectively and effectively consider and preserve creditor interests is doubtful, especially in view of the high rate of insolvency. Recently, the Supreme Court held in *BTI 2014 LLC v Sequana SA*[57] 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.[58] In *BTI 2014 LLC v Sequana,*[59] the assignees of the claim challenged the payment of dividends on the basis, among other grounds, that in causing the company to pay them, the directors were in breach of their duty to take into account creditors' interests. In May 2009 AWA's directors, who are the second and third respondents, caused it to distribute a dividend of €135m (the May dividend) to its only shareholder, the first respondent, Sequana SA, which extinguished by way of set-off almost the whole of a slightly larger debt which

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[54] *Insolvency Act, 1986*, s 213.
[55] *Insolvency Act, 1986*, s 214.
[56] *BTI 2014 LLC v Sequana* [2022] UKSC 25; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2003] B.C.C 885; *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch); *Roberts v Frohlich* [2011] EWHC 257 (Ch*); HLC Environmental Projects Ltd Re (also known as: Hellard v De Brito Carvalho')* [2013] EWHC 2876 (Ch).
[57] [2022] UKSC 25 (also known as *BAT Industries Plc v Sequana SA*); See also *Bilta (UK) Ltd (In Liquidation) v Nazir* [2013] EWCA Civ 968.
[58] *BTI 2014 LLC v Sequana* [2022] UKSC 25, [81].
[59] [2022] UKSC 25.

Sequana owed to AWA. There was a real risk that AWA might become insolvent in the future, though insolvency was not imminent at the time. Nearly ten years later, in October 2018, AWA went into insolvent administration. 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. It 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 interests of AWA's creditors. 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 Supreme Court provided certain reasons, among other reasons for its decision. Firstly, the Supreme Court held that directors' duty to promote the success of the company for the benefit of its members as a whole under s 172(1)[60] 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.[61] The apex court indicated that although directors are required to consider creditors' interests, the duty to consider creditor interest is not a free-standing duty that is owed directly to creditors.[62] 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 interest is triggered. Secondly, the duty to consider creditors' interest was not triggered in the instant case because, at the time that the dividend was paid by the directors, AWA was not insolvent or imminently insolvent and insolvency was not even probable.[63] The court held further that the duty to consider or promote creditors' interest does not apply merely because there is a real and not remote risk of insolvency. Lord Reed observed as follows.

'*…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,*

[60] Companies Act, 2006, s 172(1).
[61] [2022] UKSC 25 [11].
[62] *Id* [11], [112], [205].
[63] *Id* [116].

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'.[64]

Creditor interest only becomes paramount where an insolvent liquidation or administration is inevitable, as the shareholders cease to retain any valuable interest in the company.[65] 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 the instant case, 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 interest was also explained by the apex court. 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 creditor interests against the potentially conflicting interests of another class, such as shareholders. Whereas the duty to promote creditor interests suggests that creditors' interests predominate, if it conflicts with the interests of others, e.g., shareholders.[66] In the instant case, neither of these aspects of the duty was held to have been breached by the directors of AWA.

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' duty to promote their interest before their interests are undermined by directors;[67] whereas creditors

[64] *Id* [83].
[65] *Id* [81].
[66] *Id* [118].
[67] See the analyses in II above.

lack the capacity to effectively protect their interest, especially unsecured creditors. Since the Supreme Court has confirmed that directors' duty to consider creditors' interests is not a free-standing duty and that specific duty to creditors is not triggered, except the company is insolvent, the *status quo* is preserved. Several creditors will likely continue to experience the challenges that they were exposed to, prior to the decision of the Supreme Court. They would not likely be able to prevent their interest from being undermined before it becomes paramount, as shown in the analysis on the limitations of the *pari passu* principle above.[68] The deficiency of the argument that creditors should protect their interest via contract has already been addressed.[69] If creditors could protect their interests via contract, or even by proprietary means,[70] there would be no need for statutory and common law protection. Also, shareholders do not rely on contract for protection, they are protected by law.[71] Since shareholders and creditors are both financial stakeholders and providers of capital, and in view of the recent Supreme Court decision that confirms limited protection for creditors, additional protection for creditors is justified.

It has been argued that limited clarity has been provided in ascertaining how directors should act in furtherance of their duty to consider creditor interests.[72] Statutes have not resolved the challenge, neither has the Supreme Court. Thus, the important corporate governance question, namely, whether directors have the capacity to effectively and objectively preserve creditor interests, whilst promoting shareholder interest remains an issue. This is arguably because regulations are imperfect tools when used to make directors to act in certain ways towards

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[68] See the analysis in the first paragraph of III (a) above.
[69] Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' 66 *Modern Law Review* 665, 687-698 (2003).
[70] Louise Gullifer and Jennifer Payne, *Corporate Finance Law*: Principles and Policy 274 (3rd Edition Hart Publishing Ltd Oxford 2020).
[71] See the analyses in II above
[72] Andrew Keay, 'Directors Duties and Creditors Interests'130 *Law Quarterly Review* 443, 451 (2014) citing *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 B.C.C 30.

protecting the interests of creditors[73] and other stakeholders,[74] especially as the same directors are appointed for the predominant purpose of protecting the interest of shareholders. This dilemma can be taken off directors by requiring a designated INED to lead the role of the board in considering and preserving creditors interests when the requirement becomes triggered. Although, the Supreme Court's decision in *BTI 2014 LLC v Sequana SA,*[75] did not explain how directors should act, rather, the judgement identified the point when directors' consideration of creditor interest is triggered, by distinguishing real risk of insolvency from remote risk of insolvency.[76] The Court considered several judicial authorities, including *Bilta (UK) Ltd (in liquidation) and others v Nazir and others (no2)*,[77] a Supreme Court decision where Their Lordships, Toulson and Hodges JJSC in their joint judgement endorsed the decisions of the courts in *West Mercia Safetywear Ltd (in liq) v Dodd*[78] and *Kinsela v Russell Kinsela Pty Ltd.*[79] Their Lordships commented on the creditor's interests 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 company which is able to meet its liabilities.[80] The Supreme Court thereby confirmed its previous decision in *Bilta*[81], that as long as a company is able to meet its liabilities to creditors, creditor-interest duty in the latter part of s 172(3) is not triggered.[82] This indicates that each case would be its own example in the determination of the particular moment when this situation would arise. Despite the decision of the Supreme Court, the main problem has not been resolved. The extent to which directors that are appointed to promote shareholder

[73] See the analysis in John Quinn and Philip Gavin, 'The creditor duty post Sequana: lessons for legislative reform' 23 *Journal of Corporate Law Studies,* 271, 292 (2023).
[74] David Milman and Gary Cook, 'Managing Distressed Companies: Adapting to a New Legal Culture' 28 *Managerial Finance*, 34, 35 & 43 (2002).
[75] [2022] UKSC 25.
[76] [2022] UKSC 25, [14] [83] [199] [306].
[77] [2016] A.C. 1, [2015] UKSC 23.
[78] [1988] BCLC 250.
[79] (1986) 4 NSWLR 722.
[80] [2016] A.C. 1, [123], [2015] UKSC 23.
[81] [2016] A.C. 1, [2015] UKSC 23.
[82] [2022] UKSC 25, [79].

interests can simultaneously and objectively preserve creditor interests remains to be seen,[83] especially in view of recurrent corporate failures indicated in the data in *Table 1* above. Since the board is bound to consider creditor interests, and creditor interest is linked to the corporate interests, boards should not merely be required to be objective in considering creditors interest, they should be seen to be manifestly objective in considering and preserving creditor interests in the twilight zone. Hence, directors that are accustomed to promoting shareholder interests should be excused from this important role, by requiring a designated INED to lead the role of the board in preserving creditors interests when the creditor-interest duty is triggered by the financial condition of the corporation.

b) Delaware

In the United States, unsecured creditors rank below preferential creditors.[84] Priority among unsecured creditors is outlined in statute[85] and payments are required to be made on a fractional basis to certain unsecured creditors.[86] 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 UK, 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.

In Delaware, directors' duties are similarly owed to the corporation and exercised for the benefit of shareholders.[87] In, *Credit Lyonnais Bank Nederland, N.V. v Pathe Communications Corp.*,[88] the Delaware Chancery Court observed that, where a corporation is operating in the

[83] *Id*, see note 21 above.
[84] *Long v Bullard,* 117 U.S. 617 (1886); *Dewsnup v Timm,* 502 U.S. 510 (1992); US Securities and Exchange Commission, 'Bankruptcy: What Happens When Public Companies Go Bankrupt?' February 3 2009 https://www.sec.gov/reportspubs/investor-publications/investorpubsbankrupthtm.html accessed 6 August 2022
[85] *The United States Bankruptcy Code* § 507.
[86] For example, see Ibid § 507(4)-(8) of the Code.
[87] *Harris v Carter*, 582 A.2d 222, 234 -236 (Del. Ch. 1990).
[88] WL 277613 (Del.Ch. Dec. 30, 1991).

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.[89] This was explained in *Production Resources Group L.L. v. NCT Group, Inc*[90] where the court held that the decision in *Credit Lyonnais Bank*[91] implies that directors would be protected by the business judgment rule[92] 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.[93] This indicates the difficult position that directors are confronted with in attempting to balance the interests of shareholders and creditors who are both financial stakeholders in a corporation.

The court in *Production Resources Group L.L*[94], was not required to explore the contentious 'zone of insolvency' argument. As noted by Strine V.C., 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.[95] Strine V.C., held that the decision of the court in *Credit Lyonnais Bank Nederland, N.V. v Pathe Communications Corp*[96] that directors' duties are owed to the corporate enterprise, so as to maximize the corporation's value to best satisfy the legitimate claims of all its constituents, has been wrongly construed as requiring directors to owe fiduciary duties to creditors.[97] The court held further 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

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89 *Id*, [34].
90 863 A.2d (Del Ch. 2004).
91 WL 277613 (Del.Ch. Dec. 30, 1991).
92 See *Smith v Van Gorkom,* 488 A.2d 858, 864 Del. 1985.
93 863 A.2d (Del Ch. 2004), 788.
94 863 A.2d (Del Ch. 2004).
95 *Id*, 790.
96 WL 277613 (Del.Ch. Dec. 30, 1991).
97 863 A.2d (Del Ch. 2004). 788-789.

that do not exist.[98] In other words, *Credit Lyonnais*[99] merely provides a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations,[100] it does not confer directors with fiduciary responsibilities to creditors. The motion to dismiss creditors' claim against directors for breach of fiduciary duties was granted 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.[101] It was further stated that although creditors may be protected by covenants and other negotiable contractual protections, nevertheless, there are limitations.[102] These limitations have been examined in detail,[103] to indicate that additional protection is imperative.

The decision of the court in *Credit Lyonnais Bank Nederland, N.V. v Pathe Communications Corp*[104] and the explanations provided in *Production Resources Group L.L. v. NCT Group, Inc,*[105] have been clarified further by the Supreme Court of Delaware when it held that fiduciary duties are not owed to creditors, even when a company is at the verge of insolvency. Holland J observed in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*[106] 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…'*[107]

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[98] *Id*, 789-790.
[99] WL 277613 (Del.Ch. Dec. 30, 1991).
[100] *Id,* 788-789
[101] *Production Resources Group L.L. v NCT Group, Inc* 863 A.2d (Del Ch. 2004), 799.
[102] *Id*, 863 A.2d (Del Ch. 2004).
[103] See footnote 69 above.
[104] WL 277613 (Del.Ch. Dec. 30, 1991.
[105] 863 A.2d (Del Ch. 2004), 788.
[106] 930 A.2d 92, 99 (Del. 2007).
[107] 930 A.2d 92, 99 (Del. 2007), 101.

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. Directors are simply required to act for the benefit of shareholders even when a company is undergoing financial challenges. This is in slight contrast to the applicable regulatory framework in the UK that the duty to 'consider' creditor interest could be triggered when the company's circumstances fell short of actual insolvency.[108] The Supreme Court invariably held that rather than requiring directors to consider creditors interests, companies should be expected to be run by effective leadership that will avoid challenges to creditors if a company becomes insolvent. The Supreme Court quoted the Court of Chancery's decision in *Production Resources* with agreement, that, '*…an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership…'*[109] That *'...so long as the directors comply with their fiduciary duties to the firm by selecting and pursing with fidelity and prudence a plausible strategy to maximize the firm's value...'* any benefit to be derived by additional direct claims by creditors appears minimal, and that it would be significantly outweighed by the costs to economic efficiency.[110] Indeed, if companies have effective and proactive leadership and directors pursue corporate objectives with fidelity and prudence when a company is in the zone of insolvency, creditors' interests would not likely be undermined if the company becomes insolvent. It has been suggested that the decision of the Delaware Supreme Court on this matter is commensurately certain and convincing, by firmly requiring directors' fiduciary duty to be unchanged even when a corporation is bordering on insolvency.[111] Even though the positions of the courts in the UK and Delaware differ in respect of directors' duty in the zone of insolvency, similar problem

[108] *BTI 2014 LLC v Sequana SA* [2022] UKSC 25 [81].
[109] 930 A.2d 92, 99 (Del. 2007) 100.
[110] *Id*.
[111] Farqaleet Khokhar, 'When Do Directors' Duties Shift to Protect Creditors' Interests?' 48 *Delaware Journal of Corporate Law* 95, 98-99 (2024).

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 interest becomes paramount if the corporation becomes insolvent. In the absence of legal protection, one of the effects of the decision of the 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 Supreme Court decision is that, if the interests of creditors are undermined and the corporation becomes insolvent as a result of risky decisions taken by the board, that if successful, would have maximized the value of the corporation, directors would not likely be held liable for breach of their fiduciary duties. This was the decision of the Delaware Chancery court in *Quadrant Structured Products Co. Ltd. v. Vertin*,[112] 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 directors 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.[113] This decision followed the decision of the Supreme Court 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.[114] The risk of insolvency, which may occur as a result of poor decisions of directors that are made 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' duty to promote the corporate interest for the benefit of shareholders, whilst merely considering

[112] 115 A.3d 535 (Del. Ch. 2015).
[113] *Id*, 547.
[114] 930 A.2d 92, 99 (Del. 2007).

creditor interests, especially when a company is experiencing financial challenges. The kind of board leadership that may likely pursue corporate objectives with fidelity and prudence is the type that is provided by a designated independent non-executive director 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 Supreme Court, the requirement that directors should preserve creditors 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 creditors interests or lead to the demise of the corporation. The role of the designated INED is examined next.

IV. Preserving creditors' interest

The challenges caused by ineffective boards in preventing corporate failures largely influenced developments of corporate governance regulation in the United Kingdom[115] and the United States.[116] 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, require boards to determine what corporate governance principles they wish to comply with, and provide reasons where there has been non-compliance.[117] In Delaware, where compliance is mandatory,

[115] See the Financial Reporting Council '*History of the UK Corporate Governance Code* – 1992 available at https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code/history-of-the-uk-corporate-governance-code accessed 11th May 2021; Paul George, (Financial Reporting Council) https://assets.publishing.service.gov.uk/media/5329db50e5274a2268000045/financial_reporting_council_presentation.pdf accessed 11th May 2023.
[116] As a response to corporate scandals, including *Enron Corporation* scandal, the Sarbanes-Oxley Act 2002 was established. See also, *The Securities Exchange Act 1934 (as amended 2012)* Standards Relating to Audit Committees, (Independence) s 10A.
[117] *Corporate Governance Code*, *2018*, 'Reporting on the Code'.

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.[118] They are to confirm that they 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.[119] Both the UK and US approaches recognise the importance of an effective board towards preventing corporate failures that could lead to insolvency. If creditor interest is not preserved when an entity is solvent before their interest becomes paramount when the entity is insolvent, the paramount interest may not be capable of being protected.

The decision to engage in a risky project that could enhance returns for shareholders and potentially undermine the interest of creditors remains directors' dilemma. Although, the UK Supreme Court has delivered its judgment in *BTI 2014 LLC v Sequana SA,*[120] the dictum of David Richards LJ of the Court of Appeal in *BTI 2014 LLC v Sequana SA*[121] clearly portrays director's dilemma in considering creditors interests while promoting the interests of shareholders. His Lordship observed.

'…The reconciliation of the duty under s.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

118 *Sarbanes-Oxley Act 2002*, s 302.
119 Bob Tricker, *Corporate Governance: Principles, Policies and Practices* 129 (Oxford University Press 2019).
120 [2022] UKSC 25.
121 *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112.

foolhardy investment but, if the real risk of failure occurs, it is the creditors who will lose…'[122] This further reflects the decision of the Delaware Chancery court in *Quadrant,*[123] examined above, following the decision of the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc.*[124]

In the UK, directors may be held liable for failing to consider the interest of creditors. For example, in an action for declaratory relief in relation to an apparently insolvent company, the court held that directors failed to consider the interest 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.[125] Similarly, in *HLC Environmental Projects Ltd,*[126] the liquidators of an insolvent company succeeded in a claim against the directors for failing to consider the interests of creditors. These and other cases where directors were held to have breached their duty to consider creditor interests[127] were instituted by liquidators or the relevant insolvency practitioner when the companies were insolvent.[128] 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 apparently only be enforced at insolvency, with the risk that unsecured creditors' losses may not be remedied. In view of the continuous corporate failures, it is argued that the objective should be to prevent circumstances where creditors interests may be undermined, by requiring the board to preserve creditor interests while it promotes shareholder interests.

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[122] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 [199].
[123] 115 A.3d 535 (Del. Ch. 2015).
[124] 930 A.2d 92, 99 (Del. 2007).
[125] *Colin Gwyer & Associates Ltd & Anor v London Wharf (Limehouse) Ltd & Ors*, [2003] B.C.C 885, [5].
[126] *Also known as: Hellard v De Brito Carvalho')* [2013] EWHC 2876 (Ch).
[127] *See Micra Contracts Ltd Re (in liq)* [2016] B.C.C 153; *Roberts v Frohlich* [2011] EWHC 257 (Ch); *Loquitur Limited Re also known as The Commissioners of Inland Revenue v Richmond, Jones* [2003] EWHC 999 (Ch).
[128] Except, *Colin Gwyer & Associates Ltd & Anor v London Wharf* [2003] B.C.C 885 where the shareholders sought a declarative relief. The company was apparently insolvent.

In Delaware, the decision of the Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*[129] that the focus of the board of directors does not change even when a solvent corporation is navigating in the zone of insolvency[130] makes it unlikely for directors to be held liable for failing to consider creditor interest. This applies in the absence of fraudulent conduct and if it can be shown that the affected directors duly exercised business judgment. 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 dividend.[131] 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 interest of creditors is desirable. 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.[132] This difficulty is undesirable. As further suggested, creditors are vulnerable and directors can act as they chose, even though they are doing it with creditors' money.[133] To address directors dilemma and uncertainties[134] which are tilting towards the interest 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.

[129] 930 A.2d 92, 99 (Del. 2007),
[130] *Id*, 101.
[131] *Delaware General Corporation Law*, §§ 170, 174.
[132] Note 72, 471.
[133] Note 69, 679.
[134] See the analyses in Aurelio Gurrea-Martínez, 'Towards an optimal model of directors' duties in the zone of insolvency: an economic and comparative approach' 21 *Journal of Corporate Law Studies* 365, 379-381 (2021).

The INED can be appointed to make decisions with a committee, to determine the extent to which creditor interest has been satisfactorily considered. A set gearing ratio of a company can be used to determine when the appointment of the INED would be triggered. Ideally, the appointment can be triggered when debt level reaches certain threshold that the board would have to objectively consider whether the company should invest in further risky ventures that could either increase earnings or threaten the corporate existence.[135] 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 review the report of the executive management on the impact of a risky project on the corporate interest. Consequently, and undesirably, they would have to rely on the information that is provided by the executive management of the company.[136] Apart from the issue of information asymmetry, the limited time that INEDs spend in their supervisory roles[137] 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 experiences. 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.[138] 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. In addition, the role of the INED may

[135] *Id.*
[136] Jonathan Liu & Tomas Andersson, 'Mind the Gap: Expectations on the Role of UK Non-Executive Directors' *Regent's Working Papers in Business & Management 2014 Working Paper 1402: RWPBM1402* 1-14, 4.
[137] *Id.*
[138] Christopher Pass, 'Corporate Governance and the Role of Non-Executive Directors in Large UK Companies: An Empirical Study' 4 *Corporate Governance* 52, 59 (2004).

lead to delay in decision-making, especially where the board needs to consider an urgent risky project. 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 is preserved should take priority over speedy commencement of a project, since the interests or creditors are linked to the survival of the corporation.

The ways that the INED implement their role may determine the extent to which the board and executives would be collaborative. 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[139] of executives to help them promote corporate objectives. Thus, the role of the INED is not aimed at substituting or second-guessing the duties of the board and executive management, it should be aimed at aiding the board to perform their duties objectively. This can be achieved by ensuring regular communication about the role of the INED between the INED and 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 control measures that would keep the debt levels of corporations below the set threshold; thereby ensuring that the need to appoint the INED is never triggered. This role of the INED 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

[139] John Roberts, Terry McNulty and Philip Styles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' 16 *British Journal of Management 5*, 13-15 (2005).

view that directors could be risk averse when their companies are undergoing financial difficulties,[140] the board and the INED can weight 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.

V. Conclusion

When a corporation is operating in the zone of insolvency, it is economically reasonable to adopt a conservative approach to investment decisions, to preserve the corporation for the interests of shareholders, creditors and other stakeholders. In view of the dominant influence of shareholders over the role of directors, directors of financially challenged entities may be inclined to engage in a risky investment project, with the hope of obtaining economic gains for their shareholders; despite the risk of loss which may lead to the demise of the corporation, thereby exposing creditors to avoidable risks. Since corporate capital consist of equity and debt capital, shareholders and creditors are financial stakeholders in corporate entities and directors' duties may only generally be exercised in the interest of shareholders and creditors,[141] in view of their claims to equitable interest and property rights in the corporation.[142] The duties are not exercised in the interest of any other corporate constituents at any time. Hence it is justifiable to protect the interest of creditors when a corporation is in the zone of insolvency. Consequently, in view of the 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. It argued that the inability of directors to preserve creditor interest when a

[140] Lynn M LoPucki and William C Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' 141 *University of Pennsylvania Law Review* 669, 787 (1993).
[141] *Gans v MDR Liquidating Corp.*, Not Reported A.2d (1990), WL 2851, 9.
[142] Alan W Tompkins, 'Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception' 47 *SMU Law Review* 165, 169 (1994).

corporation is in the zone of insolvency is as a result of shareholder approach to corporate regulation. The inability of the board to ensure that creditor interests are not disregarded, has the potential to undermine the interests of creditors before creditor interest becomes paramount at insolvency.

The framework for corporate regulation in the UK and Delaware, require directors' duties to be owed to the corporation for the benefit of shareholders.[143] The analyses presented in the article show that directors' affiliations to shareholders can limit their capacity to preserve creditor interests. In both jurisdictions, there is limited scope for directors to protect creditor interests when a corporation is experiencing financial challenges; directors' duties are to be exercised in the interest of shareholders, even though a corporation is experiencing financial difficulties.[144] 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 article suggests that the interest of creditors, especially unsecured creditors can be protected by ensuring that, when the corporation operates in the zone of insolvency, a designated INED should be tasked with the duty to ascertain the extent to which creditor interest has been effectively preserved before risky investment decisions are made. This will not likely undermine the interests of shareholders since the role of the INED would invariably be aimed at helping the board to preserve the corporation. A risky project may generate significant gains for shareholders; it may also lead to the demise of the corporation. Thus, sacrificing such risky 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

[143] See II above.
[144] See the analysis of the decisions of the Supreme Courts in III above.

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. This is indicated in the analyses of the Supreme Court decisions. Even though directors are held personally liable for acting in ways that undermined creditors' interests pre insolvency, before creditor interest becomes paramount at insolvency, they may not be able to meet their company's liabilities to every unsecured creditor, if they are personally held liable for breach of duty. Thus, a preventive approach would achieve a better result, so that, as argued in this article, the role of the INED would serve as a mechanism to prevent directors from disregarding creditor interests, rather than seeking for an unavailable remedy when the corporation is insolvent.

Acknowledgements
Special thanks to *Trading Economics* New York City, for the data in Table 1.

Disclosure statement
No potential conflict of interest.

Funding
This research was not funded