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Wrongful trading, the benchmark for directors' duties: recent developments

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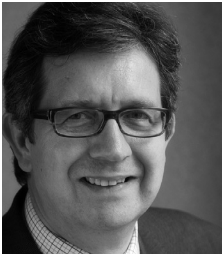

BY RICHARD BAINES
partner,
Druces LLP

BY MATTHEW McCORMICK
trainee,
Druces LLP

THE WRONGFUL TRADING PROVISIONS OF the Insolvency Act 1986[1] were introduced following the recession of the early 1980s, having been previewed in the Cork Report. Although new to English law in 1986, the concept of wrongful trading has not resulted in a plethora of cases against directors reaching court. Nevertheless, it remains significantly important, especially in today's economically challenging environment, as it provides the benchmark against which directors can judge the extent of their duties when their company is in financial difficulties. Many consider it to be slightly odd that more cases have not come to court in the quarter of a century that the law has been in place: we look at the possible reasons for that later in this article.

RECENT CASES

Two recent cases, which sit at opposite ends of the spectrum, highlight that, while the court's approach is not to stifle directors who take an active approach to managing the company's financial difficulties, those who do not do so can expect to feel the full force of the law. The cases provide an interesting contrast to each other. In one case, the court found on the evidence that the directors were vigilant and alert to the rights of creditors while being entrepreneurial and prepared to take a degree of risk. These 'good' directors were found not liable for wrongful trading. The key factors were that, firstly, the demise of their company was precipitated by the withdrawal of support by their major supplier, leaving the company on the cliff edge without a safety net and, secondly, that the directors were found to have done everything that they reasonably could to minimise the loss to creditors.

In the contrasting case, the director seemed to be oblivious of the rights of the company's creditors and, far from taking steps to minimise the creditors' losses, he appeared to put his head in the sand and ignore the company's hopeless financial position, while continuing to incur credit in a blatant fashion.

THE LAW

The first point to note is that the company must be in liquidation before a wrongful trading claim can be brought against directors: that is because the only person who can bring a wrongful trading claim is the liquidator[2]. On the application by the liquidator, the court can declare that the director is liable to make a contribution to the company's assets in an amount the court thinks proper. This means that directors who trade wrongfully lose the protection of limited liability.

By s214(2) of the Act, directors will incur liability for wrongful trading if, at some time before the commencement of the winding up, they knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation. The director's conduct is assessed by reference to a reasonably diligent person having both the general knowledge, skill and experience reasonably expected of a person carrying out the director's functions, and the general knowledge, skill and experience that the particular director actually has.

However, by s214(3) of the Insolvency Act a director will have a good defence to a wrongful trading claim if they can satisfy the court that they took every step with a view to minimising the potential loss to the company's creditors as they ought to have taken.

THE *MOND v BOWLES* CASE

In the case of *Mond v Bowles & ors* (2011), the liquidator of Langreen Ltd ('Langreen') brought claims for wrongful trading against the four company directors. The liquidator's claims against two of the directors were settled before the trial, for what were described as 'token or nuisance sums'. The trial centred around the conduct of the two remaining directors, Mr and Mrs Bowles, who had invested heavily in Langreen's business, both personally and through another company they owned (to the tune of about £500,000) and they were by far Langreen's largest creditors. Langreen's business was the provision of broadband wireless internet services to rural communities. The company was itself dependent on a satellite connection provided by a company called Aramiska. The business was a start-up commencing in around March 2004. It was short-lived, going into creditor's voluntary liquidation only about two years later in April 2006.

Giving judgment in the case, the Companies Court Registrar recognised that the company was balance sheet insolvent soon after it commenced trading. The evidence also suggested that it was cash flow

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insolvent throughout most of its history. However, relying on case law, including *Re Hawkes Hill Publishing Co Ltd* [2007], the Registrar, said that there is no duty on directors to ensure that their company does not trade while insolvent. In the *Hawkes Hill* case, Lewison J said:

> 'The question is not whether the directors knew or ought to have known that the company was insolvent. The question is whether they knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation.'

The Registrar reviewed a string of other cases on this issue, all of which pointed to the court having discretion to assess the directors' conduct: see for example, *Re Continental Assurance Company Ltd* [2001]; *Roberts v Frohlich & anor* [2011]; *Singla v Hedman* [2010]; and *Re Brian Pierson (Contractors) Ltd* [1999]. The judgment in fact provides a useful review of the wrongful trading cases that have come to court.

The liquidator based his claim for wrongful trading on the following four dates, the examination of which provides an insight into the conduct of the directors at various stages of the company's life.

Approximately five months after trading commenced

The liquidator's submissions, that the directors should have known early on that insolvent liquidation was unavoidable, were in the Registrar's view, 'based on a large measure of hindsight'. The Registrar recognised that it was a start-up business, and that Mrs Bowles was actively managing the finances.

Some seven months after trading commenced

The liquidator's 'damning picture' of the company's prospects at this stage was found to rely on a 'considerable amount of hindsight by bringing together a number of separate facts'. When looked at individually, the Registrar felt that the debts relied upon were not large and this was an important factor against placing the company into liquidation at that time. The start-up nature of the business was also recognised as an important factor and time was needed 'to see how it was going to develop'.

One year, two months after trading commenced

During this period, the directors sought to refocus the business of the company. It rationalised its service offering to its consumer customers and sought to obtain business from the business sector and internet service providers, such as AOL and Tesco. The directors at this time pursued additional investment for the business. Dealing with these facts, the liquidator argued that the company was not faring any better than previously and the directors should have concluded on this date that there was no reasonable prospect of avoiding insolvent liquidation.

Once again, the Registrar considered that as at this date:

> '... it could not be said that the company would have inevitably gone into insolvent liquidation and that the decision should have been taken to wind the company up.'

One year, seven months after trading commenced

After a potential investor reneged, the directors took steps to improve cash flow by selling equipment and leasing it back and exploring new wireless network opportunities abroad. The management accounts, however, painted a gloomy picture with turnover at about £120,000 and losses of around £140,000. The company was unable to trade unsupported. The liquidator contended that on this date insolvent liquidation was inevitable.

The Registrar considered that:

> '... with hindsight, it was very easy to conclude that Mr and Mrs Bowles were refusing to accept the reality that they had invested a large amount of money in a company which could not succeed.'

Nevertheless, the Registrar did not accept that, on the balance of probabilities, the directors should have foreseen that this was a date on which the company could continue to trade without going into insolvent liquidation.

Some three months later (in January 2006), Aramiska, the supplier of satellite services to the company, turned off its services on less than three hours notice, apparently because of its own difficulties. It was not possible to find a commercially viable alternative to Aramiska and therefore the company was unable to supply broadband services to its customers that were reliant on the satellite connection.

Within days the directors wrote to the company's customers saying that owing to the demise of Aramiska it could no longer continue to supply the services. The directors also wrote to the company's bank, saying the company intended to cease trading. Such actions were in line with the measured approach which Mr and Mrs Bowles had adopted throughout their involvement with the company. While the liquidator failed to make out his case for wrongful trading, the Registrar specifically stated that the statutory defence would have been available to them in any event, as they took all the steps they reasonably could to minimise the loss to creditors once they realised that the company could not avoid insolvent liquidation.

THE *EARP v STEVENSON* CASE

The actions of the directors in the *Langreen* case described above contrast sharply

NOTES

1) Section 214, Insolvency Act 1986.

2) Section 214(1), Insolvency Act 1986.

to those of the sole director in the other recent case concerning the director of a company called Kudos Business Solutions Ltd (KBS).

Mr Stevenson was the sole director and shareholder of KBS and sole signatory of its bank account. He had been running the company since its incorporation in 2001. The company was wound up in November 2006 on the petition of HMRC and creditors' claims totalled around £470,000. Originally, the company's business was the sale and servicing of photocopiers and the provision of office management systems. It was a small business employing only a few staff: for the financial year ended 31 July 2004, the company made a profit of only about £64,000.

Things changed in 2005 when Mr Stevenson came to an arrangement with a Mr Ramsden, for the operation of a business providing DX mailing services (that is, document exchange as an alternative to the post) as part of the company's business. At the trial the facts surrounding Mr Ramsden and the DX mail business and its connection with the company were found to be uncertain; however, it seems that this potential line of business was promoted mainly by Mr Ramsden. He used the company's stationery and an amended version of its terms and conditions when setting up agreements with customers to provide DX mailing services. Mr Stevenson's evidence (which was not accepted by the court) was that Mr Ramsden was an independent contractor who used the company's facilities, headed notepaper, logo, e-mail address but was not acting on the company's behalf.

As a result of Mr Ramsden's marketing activities the company was awarded contracts for DX services by some large organisations, including a London Borough, which resulted in advance payments of about £412,000 being made to the company's bank account. However the company was found to have no contract or arrangement of any kind with a DX provider, and it did not have the resources or the staff to itself provide the services to the customers.

Following receipt of the advance contractual payments from the company's DX customers, a very significant part of those funds were quickly paid out to Mr Ramsden (around £283,000) and Mr Stevenson (around £101,000) which dramatically reduced the funds available as working capital. Having received this very large payment, Mr Ramsden departed to Thailand in March 2006 and did not return to the UK until a considerable time after his anticipated return date. In mid-May 2006, when the company was insolvent and had almost no working capital, Mr Stevenson used £43,000 of the company's cash to purchase a Mercedes-Benz car in his own name, which he later resold, keeping the proceeds.

The contrast with the directors in the *Langreen* case is stark. Contrary to their active management, Mr Stevenson was found to have taken:

> '... an entirely cavalier attitude towards the company's creditors and at best, had no idea whether the company could afford to pay out the sums to Mr Ramsden and himself.'

While the DX venture of the business had effectively been left to Mr Ramsden, Mr Stevenson's argument that the company was not a contracting party was not found by the court to be credible.

Mr Stevenson's argument that the company would not have been insolvent if Mr Ramsden had returned on time from his Thailand trip was also given short shrift by the court, as there was no evidence that suggested that Mr Stevenson had even tried to contact him. Mr Stevenson was further hampered by the fact that he lacked contemporaneous documentation to corroborate his financial assertions. There was also no evidence to suggest that the company had contacted a DX provider in order to ascertain whether or not it would be possible to provide the required DX services.

'*The main difficulty for a liquidator considering the prospect of bringing a claim against the directors for wrongful trading is funding the litigation. There are many practical difficulties that are often insuperable.*'

The deputy judge found that Mr Stevenson was guilty of wrongful trading from 17 March 2006 onwards and she held that from that date, he knew or ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation. The deputy judge also found that the director ought to have known that the DX contracts would never be performed and that at best he had a speculative hope that they would be fulfilled if Mr Ramsden returned from Thailand. Given the company's lack of accounts, the deputy judge followed the course adopted in the case of *Re Purpoint Ltd* [1991], holding Mr Stevenson liable to make a contribution to the company's assets equal to the loss caused by the continuation of trading after 17 March 2006 quantified in terms of the aggregate of its debts after that date.

In addition, the court found that Mr Stevenson had a total disregard for his director's duties including the safeguarding of the creditors' interests. He was found liable under s212 Insolvency Act for misfeasance and breach of duty and ordered to recoup the sum of approximately £400,000 to the company together with interest, but that sum was to go towards satisfaction of his liability under s214 for wrongful trading so that there would be no double counting between the different heads of liability.

OTHER SANCTIONS AGAINST DIRECTORS

Directors of companies who commit wrongful trading face a double sanction because running in parallel with the liquidator's power to bring wrongful trading claims is the power of the secretary of state (in the guise of the Insolvency Service) to commence proceedings under the Company Directors Disqualification Act

> ***'As a detailed reading of some of the judgments in the reported cases of wrongful trading shows, the facts are often difficult to pin down without the help of forensic accountants.'***

(CDDA) 1986 on various grounds. These grounds include trading on the credit of suppliers and creditors and involve a slightly different standard of proof. However, the provisions are in other ways very similar to a wrongful trading claim, except that the claim is not brought by the liquidator and the sanction is not personal liability for the company's debts, but disqualification from acting as a company director for a period of between two and 15 years.

REASONS FOR THE SPARSITY OF SUCCESSFUL CASES AGAINST DIRECTORS

The main difficulty for a liquidator considering the prospect of bringing a claim against the directors for wrongful trading is funding the litigation. There are many practical difficulties that are often insuperable, unless one or more creditors with deep pockets are prepared to fund the liquidator's proceedings. Even the process of assessing the facts and obtaining opinions from solicitors and counsel as to the prospects of success, can be expensive and way beyond the funds left in the average smaller company in creditors' voluntary liquidation. Of course, conditional fee arrangements and after-the-event (ATE) insurance are options available to the liquidator, but these are impractical without the support of the majority of creditors, who have to be prepared to put up some money as a 'war chest'. Understandably, creditors are often reluctant to fund this type of litigation against directors and, given the choice of funding litigation or receiving a small dividend, the creditors almost invariably opt to take the dividend.

The other major obstacle for the liquidator to overcome is the difficulty in proving the case. As a detailed reading of some of the judgments in the reported cases of wrongful trading shows, the facts are often difficult to pin down without the help of forensic accountants. Then there are other risks, for example, that the judge will decide that the liquidator claimant is putting too much emphasis on hindsight. Against that, we believe the courts' attitude to allowing entrepreneurs to flourish without an excessive fear of insolvency and its repercussions is a good thing. The wrongful trading provisions have in our view worked well over the years since their introduction in 1986; in particular, they have provided a firm benchmark against which company directors can judge their own conduct as well as their duties to creditors when trading in the twilight zone.

By Richard Baines, partner, and Matthew McCormick, trainee, Druces LLP.
Email: r.baines@druces.com; m.mccormick@druces.com.

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Re Purpoint Ltd [1991] BCLC 491

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Singla v Hedman [2010] BCC 684