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# Developments in Directors' Duties under English Law

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## Introduction

In the wake of large-scale financial disruption, it is usual to anticipate that the volume of litigation involving directors will increase. Legislation may be expected to be strengthened with the aim of holding directors more accountable for the consequences of corporate failure. This article addresses the extent to which this occurred in the wake of 2008 and the extent to which it may change in the uncertain economic times we face eight years later.

While directors of financial institutions were exposed to scrutiny, in many ways it has been business as usual for directors. This partly reflects the fact that the 2008 financial crisis was generally limited to the financial, housing and construction sectors and contagion to trading companies was not significant.[1] Since that time we have seen a period of notoriously low interest rates and perhaps overly generous liquidity. Insolvency figures in Great Britain are now at their lowest level for some time.[2]

Director's disqualification orders and undertakings have correspondingly been trending downwards and have generally remained at a low level.[3] Litigation against directors following insolvency has remained relatively uncommon.[4] This might be seen to reflect the historically benign attitude towards directors in this jurisdiction. There is a general willingness to give business people discretion in the running of their companies and courts and parliament have been slow to interfere in matters of commercial judgment.

However, as always, directors have to be vigilant to change. Loose money can encourage relaxed standards and investment at overvaluation, which can be quickly undone. It seems unlikely that corporate insolvencies will remain at their current levels. It is also the case that there have been a number of legislative developments, in part driven by the experience of 2008, aimed at increasing transparency and accountability of directors, the more important of which (in respect of England and Wales) are discussed below.[5] Case law in this area has also continued to develop.

The other complication for directors is the increasingly global environment, which has a number of implications, as amply illustrated by the events of 2008. However, relevant legislation is disparate, even within Europe and the implications of insolvency are not consistent. The meaning of insolvency itself is notoriously difficult to pin down[6] (we discuss the insolvency tests used in this jurisdiction below). Recent legislative changes in Great Britain have aimed to take into account the conduct of directors overseas[7] and the experience of dealing with cross-border cases is increasing.

## Insolvency and Implications for Directors

A useful place to start is with the question of what insolvency means and why it matters to directors.

Turning first to terminology, insolvent can refer to a financial state, which in England and Wales has a meaning expressed (but not defined as a term) under statute for certain purposes. Most obviously, the grounds for winding up by the court[8] include the fact that the company is "*unable to pay its debts*". The meaning of this test is discussed further below. This statutory expression in the IA 1986 is used for a number of other purposes in the Act and also tends to drive the meaning of insolvency in England for non-statutory purposes (most commonly linked to definitions of events of default in contracts).[9]

Insolvent and the fact of insolvency can also refer to a legal state (rather than a financial state), namely the state of being in an insolvency process, most commonly liquidation and administration. In the narrower sense, legislation defines when a company "becomes insolvent" (for example, the Company Directors Disqualification Act 1986 (the "**CDDA 1986**")).

It is often noted that as a matter of English law, directors are not obliged to cease trading or apply for insolvency relief (e.g. the appointment of a liquidator or administrator) purely because the company might be "insolvent". Rather, where a company is of doubtful solvency or likely to be insolvent, the directors should shift their focus to the company's creditors and consider or act in their interest in addition to or even above the interest of its members, with a view to minimising losses. It is often argued that the directors should not cease trading just because the company is insolvent if that would not minimise the losses that creditors might suffer. Directors may be justified in thinking they should do whatever they can to rescue the company, rather than see it enter an insolvency process. This contrasts with the position of directors in other jurisdictions, where the consequences of insolvency are more prescriptive.

However, the significance of insolvency to a company's directors requires further thought. Directors are usually advised to seek formal advice, for good reason. It is a somewhat obvious statement that the fact of insolvency, expressed in a broad commercial sense, may lead to the commencement of insolvency proceedings. Directors of companies that have become insolvent in this sense face disqualification, personal liability for damages or compensation and potential criminal liability.

While this article does not analyse the CDDA 1986 in detail, it is useful to illustrate the significance of procedural insolvency. The CDDA 1986 provides a regime for the disqualification of directors by court order (following an application by the Secretary of State) or by an acceptable undertaking from the individual not to act in the management of a company for a period.

A company becomes insolvent for the purpose of the CDDA 1986 if: (1) it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up; (2) the company enters into administration; or (3) an administrative receiver of the company is appointed.[10] If a director is or has been a director of a company which has at any time become insolvent, the CDDA 1986[11] requires the court to make a disqualification order against the director if it is satisfied that his conduct as a director of that company[12] makes him unfit to be concerned in the management of the company. This is the most common basis for a disqualification order.[13]

Whether a company has become insolvent in its procedural sense will further impact on the factors that are taken into account in determining whether a director is unfit.[14] The fact that the director was trying to minimise losses to creditors in continuing to trade is not expressly a relevant factor and directors may find that in doing so they engage in other conduct which is relevant. For example, the extent to which the directors are responsible for failing to supply goods or services which have been paid for (in whole or in part) is a relevant matter.[15] These factors have recently been updated and extended, as described in more detail below.

The fact that a company is subject to insolvency proceedings also exposes the directors to possible remedies under the IA 1986. It is a pre-requisite to actions for wrongful trading,[16] fraudulent trading,[17] as well as orders for transactions at an undervalue[18] and preferences.[19]

It is in this context that insolvency in the financial sense becomes relevant.[20] Hence, it is relevant for directors to identify the time when the company becomes insolvent in a financial sense.

## Recognising the Insolvency Tipping Point

There are two generally accepted statutory insolvency tests which may be applied in corporate insolvency cases. A debtor may be said to be insolvent if:

(a) it is unable to pay its debts as they fall due (known as the "cash flow" test);[21] or

(b) the value of its assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (known as the "balance sheet" test).[22]

The cash flow test is concerned, not only with whether a debtor is able to pay its debts that are immediately due and payable, but also with debts falling due from time to time in the "reasonably near future". Once the court has to move beyond the "reasonably near future", any attempt to apply the cash flow test will become "completely speculative" and the balance sheet test becomes the "only sensible test".

The balance sheet test is not whether the debtor has reached "the point of no return". Nor will it be satisfied by simply checking whether the debtor's most recent balance sheet shows that its liabilities exceed its assets. Instead, the test requires the court to decide whether, on a balance of probabilities, it has been established that, looking at the debtor's assets and making proper allowance for its prospective and contingent liabilities, it cannot reasonably be expected to be able to meet all of its liabilities. The burden of proof lies with the party seeking to satisfy the test.[23]

Neither test is an exact science For example, what constitutes the "reasonably near future" for the purposes of the cash flow test will depend on all the circumstances of the case and, in particular, the nature of the debtor's business. Similarly, the more distant the liabilities and the more "imponderable factors" there are which will determine whether the debtor is able to satisfy its debts at maturity (such as currency movements, interest rates and the state of the UK economy), the more difficult the balance sheet test is to apply. In all but the most straightforward cases, directors should proceed cautiously and seek specialist advice to avoid inadvertently missing the "tipping point" of insolvency.

## Recent Legislative Developments

The SBEEA 2015 has introduced a number of changes to existing legislation which will be relevant to directors. The Act is part of the UK Government's broader initiative to enhance transparency and trust in UK businesses, by increasing the accountability of those involved in corporate management whose conduct falls below an acceptable standard.[24] Some of the key changes include:

(a) **Power for a liquidator or administrator to assign causes of action** – Liquidators and administrators are now able to assign causes of actions that arise on a company going into liquidation or administration (e.g. fraudulent or wrongful trading claims and other "claw back" actions, such as preference and transaction at an undervalue claims) and the proceeds of such action to a creditor, group of creditors or a third party. Often, liquidators and administrators will decide against pursuing a claim against a director, due to the cost and time involved and the risk that the claim will be unsuccessful. Disgruntled parties with deeper pockets than the office holder will now have the opportunity to purchase and pursue a claim for their own benefit.

(b) **Power for administrator to bring fraudulent or wrongful trading claims** – It used to be the case that only a liquidator could bring these civil claims against a director. To increase the prospect of culpable directors being held accountable and financial redress for creditors, the IA 1986 has been amended to extend this power to administrators. Time will tell whether this will lead to an increase in claims.

(c) **Extension of directors' statutory duties to shadow directors** – The SBEEA 2015 has clarified that the general duties of directors specified under the CA 2006 apply to shadow directors of a company where and to the extent that they are capable of applying. A breach of these duties in relation to a company may entitle an office holder to bring a claim against misfeasant shadow directors. Additionally, there is the risk of disqualification from acting as a director under the CDDA 1986.

(d) **Register of persons with "significant control" over the company** – From April 2016, companies (excluding publicly trading companies) will have to create and maintain such a register, which will be publicly available via Companies House and must be updated annually. This may assist liquidators and administrators in their investigations into the conduct of management in the lead up to insolvency, not least to identify shadow directors.

The SBEEA 2015 has also introduced a number of robust amendments to the CDDA 1986.

- **Two new grounds for disqualification**:
  - the Secretary of State may apply for a disqualification order against a director who has been convicted of serious offences in connection with the promotion, formation or management of a company overseas; and
  - the disqualification regime has been extended to persons who are not directors but who exert requisite influence over a director. Where a director is disqualified, and any of the conduct which led to his disqualification is attributable to a person giving him or her instructions or directions, that person may also be disqualified.
- **Broadening of matters to be taken into account when determining disqualification** – These have been updated and extended to include the individual's conduct in relation to more than one company, including overseas companies.
- **Compensation orders and undertakings** – The court has a new power to make a compensation order against an individual (on the application of the Secretary of State),

where the conduct for which that individual has been disqualified has caused loss to one or more creditors of an insolvent company of which they have at the time been a director. Alternatively, the Secretary of State may also accept a compensation undertaking from the individual. A director against whom an order is made will be required to pay a specified amount to the Secretary of State for the benefit of a specified creditor, class of creditor or as a contribution to the assets of the insolvent company. When deciding on the amount of compensation, the Court/Secretary of State must in particular have regard to the amount of the loss caused, the nature of the misconduct and whether the person has made any other financial contribution in recompense for the conduct (whether under a statutory provision or otherwise, e.g. pursuant to a compensatory order made in a wrongful trading action[25]). At first glance, it appears that it might be easier to recover compensation under this new regime, than pursuant to a wrongful or fraudulent trading claim which, historically at least, have been hard to prove.

These changes will increase the existing burden on those individuals involved in the management of companies. Time will tell whether they will lead to an increase in successful enforcement action against them too. The increased robustness of the disqualification regime and the introduction of compensation orders and undertakings in disqualification cases may improve financial redress for creditors. The statutory duties of directors are supplemented by case law, and there have been a number of wrongful trading decisions recently which may also increase the prospect of successful actions being taken against culpable directors.

## Claims Against Misfeasant Directors

If a director acts in breach of the duties he owes to a company, the company has a cause of action against him. In insolvency, such claims are usually advanced by liquidators. The IA 1986 provides a summary procedure designed to enable claims against directors (and other officers of the company) to be made quickly and easily so that the insolvent company can avoid the time and expense of full-scale litigation proceedings. The procedure is set out in section 212 of the IA 1986. The court has the power to require a delinquent director to repay, restore or account for money or property or to contribute such sum as the court thinks just to the company's assets in order to compensate creditors for any losses caused by the director's delinquent conduct.

It is important to note that claims brought under section 212 are not statutory claims;[26] these provisions simply provide a statutory framework within which to advance the claims. Consequently, the relevant limitation period for bringing such claims does not arise from the date of the appointment of a liquidator but from the date when the company's cause of action arose.[27] Where a claim against directors alleges a negligent breach of duty, those directors could claim a contribution from any professional advisers on whose advice they relied.[28]

If the claims involve a company incorporated outside of England & Wales, the duties owed by the directors of those companies will be determined by reference to the law of the State in which the company is incorporated. However, section 212 can be used to enforce those duties (see below).[29]

Claims brought under these provisions are a chose in action of the company and, consequently, any compensation derived from the claims may be secured by an existing charge. (Contrast this with the position in relation to compensation paid to the company in relation to claims for wrongful or fraudulent trading. Because these causes of action arise only in the event of an insolvency, these claims (and any compensation paid in respect of them) are assets of the company which could be secured by a pre-existing or future charge.)

Claims may also be brought under section 212 by a creditor directly but any compensation order made will be made in favour of the company and not the applicant creditor.

## Wrongful Trading

Section 214 of the IA 1986 provides office holders with a statutory claim against directors in the following circumstances:

- the company has gone into administration/insolvent liquidation;
- prior to the commencement of the winding up, the person against whom a claim is made knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation; and
- that person was a director of the company at that time.

The section provides that the facts which a director ought to know or ascertain, the conclusions which he ought to reach and the steps he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the director and the general knowledge, skill and experience that the director in question actually has. In other words, there is a base level of knowledge, skill and experience by which all directors will be judged (regardless of whether they actually possess it) but if they have a superior level of knowledge, skill and experience, they will be judged by that higher standard.

Even if the court finds that there has been wrongful trading, it will not make a declaration that one or more of the directors must make a contribution to the assets of the company if it is satisfied that the director "*took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken*".[30] This is often referred to as the 'minimum loss defence'.

In the recent case of Grant & Another -v- Ralls & Others,[31] the Judge held that whilst the directors ought to have concluded there was no reasonable prospect that the company would avoid insolvent liquidation, the continued trading had not caused loss to the company overall or worsened the position of creditors generally. In the circumstances, he declined to make an order requiring the directors to contribute to the assets of the company.

It has long been considered that the burden of proof in establishing that directors had failed to take 'every step' (so that the minimum loss defence did not apply) lay with the office holder bringing the claim. However, in Brooks & Another -v- Armstrong & Another,[32] the Registrar held that the burden of proof in establishing that every step was taken to minimise losses to creditors was with the directors not the office holder provided that the office holder had successfully established that the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation (the knowledge test). He said this was the natural and ordinary meaning of the words used in section 214 and that it did not make sense for office holders to prove that the directors had failed to take 'every step'.

The Registrar also held that 'every step' meant every step and not, for example, every reasonable step. On the facts of this case, the Registrar found that if the company had entered administration or liquidation sooner, losses to creditors would have been minimised and, therefore, the directors had not taken every step they could have done so the minimum loss defence was not available to them.

The board consisted of an executive and a non-executive director. Both were sued by the liquidator for wrongful trading. Under section 214, directors are severally liable for any losses suffered and the contribution (if any) that a director must make is assessed independently of claims being made against his fellow directors. The non-executive director claimed he should not be required to contribute to the assets of the company as all of the relevant decisions had been made by the executive member of the board. The court was unimpressed with that defence and found that the non-executive director was jointly and severally liable for the amount of compensation the executive director had been ordered to pay because he either was or ought to have been a party to the relevant decisions to continue trading.

Historically, liquidators have been slow to bring wrongful trading claims because they are difficult to prove. Following this decision, we can expect to see more claims being brought as it is much more likely that administrators and liquidators will be able to form a view on whether they can satisfy the knowledge test leaving directors struggling to prove they can take advantage of the statutory minimum loss defence. Consequently, directors are now much more exposed to claims of wrongful trading and must make sure that they fully document their decisions and support those decisions where possible with up-to-date financial statements, projections and business plans.

## Fraudulent Trading

Section 213 of the IA 1986 provides a further statutory cause of action known as fraudulent trading. If the business of a company has been carried on with an intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the court may declare that any persons who were knowingly parties to the carrying on of that business are liable to make such contributions to the company's assets as the court thinks proper.

Prior to the SBEEA 2015 coming into force, this was a statutory remedy only available to liquidators. Now the SBEEA 2015 is enacted, this remedy (and wrongful trading) are claims that can also be brought by administrators. Despite the fact they are statutory causes of action, the SBEEA 2015 provides that they (or the proceeds of the actions) can be assigned by an office holder.

The section is very widely drafted and can include frauds committed against creditors such as HM Revenue & Customs. The Supreme Court has now confirmed the decision of the Court of Appeal in the Bilta case[33] deciding that section 213 has extra-territorial effect and the words "*any person*" extend to persons outside of the jurisdiction of the English courts. This is an unsurprising decision given the desire of the courts to ensure that there are effective remedies in place to deal with insolvent companies trading on an international basis.

## Recognition of Foreign Insolvency Proceedings for the Purpose of Enforcing Directors' Duties

The Cross Border Insolvency Regulations 2006 ("**CBIR**") came into force in England & Wales and Scotland on 4 April 2006. They enact legislation based on the Model Law on Cross Border Insolvency adopted by the UN Commission on International Trade Law in 1997. The Model Law is designed to provide a framework which, when adopted by enacting States, will provide a consistent approach to insolvency laws and regulation to assist in providing an orderly and consistent regime in insolvencies which have an international reach.

The CBIR enacts the Model Law and applies to foreign insolvency proceedings anywhere in the world without requiring reciprocity from the State which is seeking to obtain recognition of its own insolvency proceedings. Where there is any conflict between the CBIR and the EC Regulation on Insolvency Proceedings, the EC Regulation prevails.[34]

The CBIR provides a streamlined procedure to facilitate the recognition of foreign representatives in non-domestic insolvency proceedings and to seek relief directly from the English courts. Once recognition of the foreign proceedings has been obtained, the English court can grant relief to the foreign representative in accordance with Article 21 of Schedule 1 to the CBIR. Relief will be granted "where necessary" to protect the assets of the debtors or the interests of creditors.

The court can grant any appropriate relief including:

- Staying the commencement or continuation of individual proceedings concerning the debtor's assets.
- Staying execution against the debtor's assets.
- Suspending the debtor's right to transfer, encumber or otherwise dispose of assets.
- Providing for examination of witnesses, taking evidence, or the delivery up of information concerning the debtor's assets, affairs, rights, obligations or liabilities.
- Entrusting the administration or realisation of all or part of the debtor's assets located in Great Britain to the foreign representative or another person designated by the court.
- Extending relief granted under paragraph 1 of Article 19 (provisional relief granted to the foreign representative when the application is made).
- Granting any other relief that may be available to a British insolvency officeholder under the laws of Great Britain.

Accordingly, provided recognition is obtained, foreign representatives in non-domestic insolvency proceedings will be able to seek to enforce directly any claims they may have against a debtor's assets in Great Britain. This will include claims for compensation under sections 212, 213 and 214 of the IA 1986.

Within the EU (with the exception of Denmark), the EC Regulation on Insolvency Proceedings has direct effect within all Member States. Insolvency proceedings opened within a Member State must be recognised in all other Member States without further formality to ensure the orderly administration of insolvency proceedings instituted in different Member States.

## Conclusion

Recent legislative changes and court decisions reflect the current economic environment and the desire of government and courts alike to ensure that those in charge of companies act responsibly and in accordance with their statutory duties to shareholders and creditors. In particular, those who take non-executive director positions for prestige reasons in the hope or expectation that they will not be accountable in the event of a corporate failure will suffer a rude awakening if it is ultimately determined that the directors are culpable for or contributed to the losses suffered by the company and its creditors. Increasingly, the courts are adopting a uniform approach in assessing the culpability of executive and non-executive directors and non-executive directors cannot now expect to be absolved from liability because they have taken a 'light touch' approach. Similarly, the SBEEA 2015 makes it clear that those who seek to operate a company from behind the scenes will not escape liability and instead will be held accountable in the same way as statutory directors.

The prosecutions that have taken place arising out of recent financial scandals indicate that the prosecuting authorities and the courts are seeking to send a message that individuals who are involved in conduct which falls below the prescribed standard can expect to be held accountable. Whilst the fallout from the 2008 financial crisis has not impacted significantly on those outside directly affected sectors, directors who are involved in corporate failures should expect a greater level of scrutiny concerning their conduct. The requirement to keep complete and accurate records and take fully informed professional advice at every stage has never been more important.

## Endnotes

1. Retail sales were affected, notably impacting businesses like Woolworths, MFI and Blacks.
2. Total company insolvencies are at their lowest for 26 years, according to the Annual Company Insolvency Statistics for England and Wales published by the Insolvency Service, October to December 2015.
3. Insolvency Service Enforcement Outcomes (Experimental Statistics), October to December (Q4) 2015.
4. Since 1986 there have only been around 30 reported wrongful trading cases, about 50 preference claims and about 80 reported cases arising from undervalue transactions. (Source: Transparency & Trust: Enhancing the transparency of UK company ownership and increasing trust in UK business: Government Response (April 2014).)
5. Small Business Enterprise and Employment Act 2015 (the "SBEEA 2015"), which received Royal Assent on 26 March 2015.
6. This is reflected in the fact that no attempt has been made to define insolvency in the main European legislation governing cross-border insolvency regimes, Council Regulation (EC) No. 1346/2000 on Insolvency Proceedings (the "EC Regulation on Insolvency Proceedings") – see Virgos Schmidt Report on the Convention on Insolvency Proceedings (at paragraph 49).
7. Section 104, SBEEA 2015, discussed further below.
8. Section 122, Insolvency Act 1986 (the "IA 1986").
9. However, "insolvent" when used as a term outside statute must take its meaning from the context.
10. Section 6(2), CDDA 1986.
11. Section 6(1), CDDA 1986.
12. Either taken alone or taken together with his conduct as a director of any other company or companies.
13. Insolvency Service Enforcement Outcomes, October to December 2015.
14. Section 9, CDDA 1986.
15. However, in Re UNO & another plc; SSTS -v- Gill & Others [2004] EWHC 933 (Ch) the Court endorsed the conduct of directors accepting customer deposits while hoping to trade the company out of its difficulties.
16. Section 214(2), IA 1986 applies if 2(a) the company has gone into "insolvent liquidation".
17. Section 213, IA 1986 which applies in a winding up.
18. Section 238(1), IA 1986.
19. Section 239(1), IA 1986 which both apply where a company has gone into liquidation at administration.
20. Wrongful trading requires proof that the director knew or ought to have concluded that there was no reasonable prospect of avoiding going into insolvent liquidation.
21. Section 123(1)(e), IA 1986.
22. Section 123(2), IA 1986.
23. *Re* Cheyne Finance (No. 2) [2008] Bus LR 1562; BNY Corporate Trustees Limited and others -v- Eurosail-UK 2007-3BL plc & others [2011] EWCA Civ 227.
24. Transparency & Trust: Enhancing the transparency of UK company ownership and increasing trust in UK business: Discussion Paper (July 2013).
25. This could mean that a director could be personally liable to make a contribution under more than one order. The basis of calculation of any contribution under section 214 IA 1986 has not yet been clearly decided by the courts, although case law has clarified that the purpose of this section is compensatory (i.e. designed to recoup the loss to the company resulting from the wrongful trading attributable to the director), not penal. It follows that in order to establish a maximum liability (subject then to the exercise of the court's discretion), the loss will normally be represented by the amount that the company's assets have been depleted and/or its creditors have increased as a result of the director's wrongful trading.
26. Compare sections 213 and 214 IA 1986 which do establish statutory causes of action.
27. *Re* Eurocruit Ltd [2007] EWHC 1433 (Ch).
28. *Re* International Championship Management Ltd [2006] EWHC 768 (Ch).
29. Base Metal Trading Ltd -v- Shamurin [2004] EWCA Civ 1316.
30. Section 214(3), IA 1986.
31. [2016] EWHC 243 (Ch.), Re Ralls Builders Limited (in liquidation).
32. [2015] EWHC 2289 (CH), Re Robin Hood Centre Plc (in liquidation).
33. Bilta (UK) Limited (in liquidation) & Others -v- Nazir & Others [2015] UKSC 23.
34. See Article 3 of Schedule 1 of the CBIR.

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- Merger Control
- Mergers & Acquisitions
- Mining Law
- Oil & Gas Regulation
- Outsourcing
- Patents
- Pharmaceutical Advertising
- Private Client
- Private Equity
- Product Liability
- Project Finance
- Public Procurement
- Real Estate
- Securitisation
- Shipping Law
- Telecoms, Media & Internet
- Trade Marks

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