Case
Re Continental Assurance Co of London plc (27 April 2001, Ch D, unreported)

Synopsis
The decision in Re Continental Assurance deserves to be regarded as one of the most significant pronouncements on section 214 of the Insolvency Act 1986 to date. The trial of the action lasted 72 days and required the court to grapple with a welter of complex issues, both factual and legal. Park J's mammoth judgment is accordingly not for the faint-hearted. However, it contains a detailed and careful analysis of several aspects of section 214 and provides a useful illustration of the pitfalls facing office holders who might be contemplating proceedings.

Topics covered: Directors' duties

The Facts

Continental was a small insurance company that went into creditors' voluntary liquidation in March 1992. The company suffered heavy losses during 1990 as a result of unexpectedly high travel insurance claims. Its eventual collapse stemmed from the failure to make adequate provision for these claims in the company's reserves. The liquidators brought section 214 proceedings against the former managing director and several of the company's former non-executives. Broadly speaking, their case was that the directors should have ceased trading in mid-1991, around the time when the losses were first reported.

The "knowledge" issue

A person can only be liable under section 214 where:

A company has gone into insolvent liquidation (meaning that its assets are insufficient for the payment of its debts, other liabilities and the expenses of winding up).
At some time before the commencement of the winding up of the company, (s)he knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

(S)he was a director or shadow director of the company at that time.
It should be noted in passing that the provision also now applies to the members of an insolvent limited liability partnership by virtue of the Limited Liability Partnerships Regulations 2001 (SI 2001/1090).
In Continental Assurance the only point in issue on liability was whether in mid-1991, the directors knew or ought to have concluded that there was no reasonable prospect that Continental would avoid insolvent liquidation. The liquidators' primary case was (a) that as a result of the travel insurance losses Continental was "balance sheet" insolvent in July 1991 and had no prospects of survival and (b) that the directors knew or ought to have realised this and would have so realised had they applied appropriate accounting policies. Accounts prepared specifically for consideration by the board at crisis meetings during July 1991 suggested that Continental had net assets of about £4.5million. This figure reflected a serious erosion of capital but led the directors to conclude that the company was solvent and could continue to trade while efforts were made to find a buyer. Relying on expert evidence, the liquidators contended that aggregate adjustments of over £5million should have been made to the accounts that, if made, would have shown Continental to be insolvent in July 1991. It was alleged, for example, that the accounts made inadequate provision for claims "incurred but not reported", i.e. claims arising from events that had occurred within an accounting period but had not been notified to Continental as at the accounting date.
The liquidators' secondary case was (a) that, even if Continental was solvent in July 1991, it did not

comply with the DTI margin of solvency applicable to insurance companies and, as such, had no prospects of survival and (b) that the directors knew or ought to have realised this.

The Decision

Weighing both sides' expert evidence, Park J found, on the balance of probabilities, that the company was still technically solvent in July 1991 but was in breach of the DTI's margin requirement. However, he held that the defendants were not liable and stressed that he would have reached the same conclusion on liability had he found that the company was factually insolvent in July 1991. On the basis of the information available to them at the time, the defendants had acted reasonably in deciding that Continental could continue trading with a view to finding a buyer for the business. When the losses were first reported, the board had specifically raised the question of whether the company could properly continue to trade. The finance director and the auditors had been instructed to conduct a detailed appraisal of Continental's financial position. At every board meeting during the crisis period, assurances had been sought from the finance director and from the auditors that Continental was still solvent. When further losses were reported leading the directors to conclude in December 1991 that Continental had become insolvent, they gave instructions that it should not carry out any more new business and took advice from insolvency practitioners. In the words of the judge, "the directors... took a wholly responsible and conscientious attitude, both to Continental's position and to their own responsibilities as directors." Park J's conclusions on liability can be justified by reference to section 214(4). The effect of section 214(4) is that a director can only be liable if the court finds that a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has, would have decided to cease trading. This test sets an objective minimum standard which obliges all directors to acquire and maintain a basic knowledge of the company's financial position: see e.g. Re Brian D Pierson (Contractors) Ltd [1999] BCC 26. In the judge's view, the standard to be applied to Continental's directors was that of the "intelligent layman". Directors in their position would be expected to have a basic grasp of basic accounting principles applicable to insurance companies, such as IBNR. They would also be expected to be able to read and understand the company's accounts, to participate in discussion of the accounts, and to ask intelligent questions of the finance director and auditors. However, it was setting the standard too high to expect them to have the specialist knowledge of an expert in the field of insurance company accounting. The evidence showed that Continental's directors were active in keeping the company's financial position under close and continuous review. A reasonably diligent person in their position could not have been expected to do any more. On the same basis, it was also reasonable for the directors to conclude from the material available to them that Continental was still operating within the DTI's margin of solvency in July 1991 even though, in hindsight, it was established that this was probably not the case.

Quantum

As the matter had been fully explored by both sides during the trial, Park J addressed the issue of quantum even though in the light of his findings on liability it did not strictly arise. The following points were made:

The section states that the director "is to be liable to make such contribution (if any) to the assets of the company as the court thinks proper". As such, the court clearly has a discretion whether or not to order a contribution. However, that discretion is not entirely at large. The basic measure is the increase in the net deficiency that arises as a result of the liquidation being delayed.

However, any contribution ordered will not necessarily equate to the increase in net deficiency. In fixing the size of the contribution, the court must consider whether there is a sufficient connection between the increase in net deficiency and the factors which made the decision to continue trading wrongful. Thus, before the court will be prepared to order contribution, it is not enough for the liquidator to say, on a "but for" basis, that if the company had ceased trading, a particular loss would not have been suffered. There is an onus on the liquidator to explain each element of the increased deficiency and to connect it to the unlawful conduct of the directors. Not every loss sustained after the directors reach a wrongful decision to continue trading (or wrongfully fail to consider the question of whether or not the company should continue trading) is recoverable: see e.g. Re Brian D Pierson (Contractors) Ltd [1999] BCC 26.

Where applications under section 214 are made against two or more directors the starting point is that their liability is several. This does not preclude the court from imposing joint and several liability in the exercise of its discretion. However, the focus of the section is on the individual director rather than on the collective conduct of the board of directors. For this reason, joint liability should only arise where the court positively exercises its discretion to impose it. On the evidence, Park J held that the liquidators had failed to establish any increase in net deficiency between July 1991 and March 1992. Thus, he would have made no order against the defendants even had the liquidators succeeded on the liability issue.

Comment

Continental Assurance is a good illustration of how difficult it can be to bring successful wrongful trading proceedings in cases where the board of directors functioned properly and made decisions on the basis of an up-to-date appraisal of the company's financial position. In such cases, the court is likely to take great care to ensure that its view of the defendants does not become too coloured by hindsight. Indeed, the judge in Re Sherborne Associates Ltd [1995] BCC 40, warned of "the danger of assuming that what has in fact happened was always bound to happen and was apparent." Moreover, there is concern in some quarters that too casual a use of section 214 could deter skilled individuals from taking up directorships. As Park J himself said, "...I cannot refrain from remarking that, if the non-executive directors were liable to pay millions of pounds to the liquidators in this case, it is hard to imagine any well-advised person ever agreeing to accept appointment as a non-executive director of any company." The courts may be less forgiving in cases where the directors failed to keep proper financial records (see e.g. Re Produce Marketing Consortium Ltd (No 2) [1989] BCLC 520; Re DKG Contractors Ltd [1990] BCC 903; Re Purpoint Ltd [1991] BCLC 491) or buried their heads in the sand in the hope that the company's problems would go away or engaged in fraudulent practices (on the latter point, see Official Receiver v Doshi [2001] 2 BCLC 235) but the facts of Continental Assurance did not fall into any of these categories. In line with Re Sherborne Associates Ltd [1995] BCC 40, Continental Assurance requires the liquidator to identify a precise date or dates on which it is alleged that the defendant knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. This is consistent with the statutory expression, "at some time". Thus, out of fairness to the defendant, the liquidator will not be allowed to plead that the company had no reasonable prospect of avoiding insolvent liquidation "at such date as the court may determine". The liquidator must specify a date (or dates), and stand or fall by reference to the date(s) specified.

Finally, it is clear from the transcript that Park J was not entirely happy with the way in which the case was conducted, especially prior to the issue of proceedings. The directors had not heard from the liquidators in over five years and were given no indication that proceedings were to be issued against them. Much of the liquidators' pleaded case was based on a report drawn up by Coopers & Lybrand Insurance Services (who carried out the run-off of Continental's business). This contained several allegations and criticisms that Park J felt could usefully have been put to the directors before proceedings were commenced. The message seems to be that although insolvency litigation is not the subject of a pre-action protocol, the liquidator and his legal team will be expected to conduct the pre-action phase of proceedings in accordance with the spirit of the CPR.