DIRECTORS' DUTIES TO CREDITORS AND FINANCIALLY DISTRESSED COMPANIES

ANDREW KEAY

AIM

- To examine what are duties of directors under the Companies Act 2006 as far as creditors are concerned
- To ascertain when directors have to consider creditors' interests
- To ascertain the inter-relationship between s.172(1) and s.172(3).

BACKGROUND

- Company law reform
- Asked : for whom are directors to exercise their duties?
- Considered shareholder value approach as against pluralism
- Settled on enlightened shareholder value approach
- Carried forward into legislation – 2 limbs – ss.172(1) and 417 Companies Act 2006

- Directors have a general duty to promote the success of their company for the benefit of the members as a whole (s.172(1))
- Follows on from the common law duty to act bona fide in the best interests of the company
- The s.172(1) duty provides for a shareholder value approach to company law
- The ultimate beneficiaries of the exercise of the directors' duties is the shareholders and no other stakeholders

A PARAMETER ON APPLICATION

- The duty in s.172(1) has effect subject to any enactment or rule of law that requires directors, in certain circumstances, to act in the interests of the creditors of their company (s.172(3)).
- Explanatory notes to the Companies Act 2006 at para 331 recognise that this provision displaces the application of s.172(1).

- Paragraph 332 provides that the requirement 'to promote the success of the company will be modified by the obligation to have regard to the interests of creditors as the company *nears* insolvency' (my emphasis).
- This recognises the common law developments in the UK and around the Commonwealth over the past 30-35 years as far as taking into account creditor interests is concerned

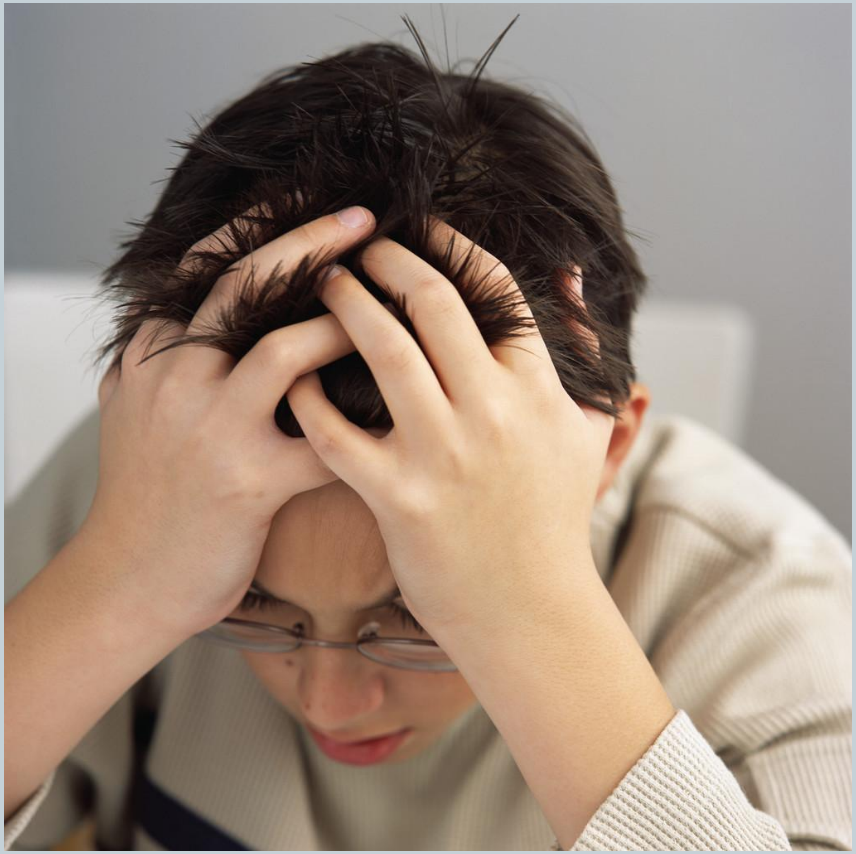
- Also one would think that the demands of s.214 of the Insolvency Act 1986 (wrongful trading) would also displace the s.172(1) duty.
- Section 214 requires directors to take every step with a view to minimising the potential loss to the company's creditors. But this is only when the directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.
- This interpretation ensures that there is no conflict between s.172 and s.214

- This would mean that if directors acted in accordance with the requirements of s.214, when the circumstances envisaged by the section applied, the shareholders would not be successful in claiming a breach of s.172(1) through derivative proceedings.

THE BIG QUESTION

- What are ‘the certain circumstances’ that will entail the displacement of the s.172(1) duty?
- Critical – so that the directors know how they should operate.
- The difficulty for directors appears to be knowing when they must move from complying with s.172(1) to complying with s.172(3)
- They could be treading a fine line and caught between the two provisions

WHAT DO WE DO??



- If the certain circumstances do not exist then shareholders might take action if directors act in the take creditors' interests
- If the certain circumstances do exist and directors do not act in the creditors' interests then there might be a subsequent action brought by a liquidator at a later date if the company enters liquidation

- The obligation imposed on directors to consider the position of creditors has developed over the years as a mechanism to stop companies externalising the cost of their debts at the time of financial distress
- To prevent directors, perhaps under pressure from shareholders, from 'gambling the farm'
- The creditors are the primary stakeholder

INSOLVENCY

- The English and Commonwealth cases unequivocally provide the if a company is insolvent then the directors are obliged to act in creditors' interests (e.g. *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30 at 33 (CA) - where a company is insolvent, the creditors' interests overrode the interests of the shareholders; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215; (1986) 10 ACLR 395) and also in Ireland (*Re Frederick Inns Ltd* ([1994] ILRM 387; [1993] IESC 1)

- Subsequent English cases have supported this approach, e.g., *Re Pantone 485 Ltd* [2002] 1 BCLC 266 at [69]; *Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748; [2003] BCC 885 at [74]; *Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch); [2004] EWHC 42 (Ch); [2005] BCC 783; [2004] 1 BCLC 217; *Re Cityspan Ltd* [2007] EWHC 751 (Ch); [2008] BCC 60
- Although this might seem clear, the difficulty may be in determining whether the company was insolvent at a particular point.

WHEN IS THERE A SHIFT IN DUTY?

- There are four categories when there might be a shift according to case law
- First, it is said that directors can be subject to the obligation when their company is :
  - **nearing insolvency** (*The Liquidator of Wendy Fair (Heritage) Ltd v Hobday* [2006] EWHC 5803 at [66]**)**
  - **on the borderline of insolvency (***Eastford Limited v Gillespie, Airdrie North Limited* [2010] CSOH 132 at [22])
  - **on the verge of insolvency (***Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] BCC 885; at [74]).

- Second, where the company is of doubtful solvency (*Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] BCC 885; at [74])
- Third, where the company is subject to a risk of insolvency (*Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215 at 223; *Winkworth v Edward Baron Development Ltd* [1986] 1 WLR 1512)

- Fourth, there are other cases where no reference to insolvency is made at all and they have been content merely to say that the company must be in some financial predicament such as :
  - **A dangerous financial position** (*Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 BCLC 218 at 228)
  - **In a parlous financial state** (*Williams v Farrow* [2008] EWHC 3663 (Ch) at [21])
  - **Being financially unstable** (*Linton v Telnet Pty Ltd* [1999[NSWCA 33; (1999) 30 ACSR 465)
  - **In financial difficulties** (*Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch); [2004] EWHC (Ch) 42; [2005] BCC 783 at [70])

- It is difficult to formulate principles
- The cases have said that a company can be in a dangerous position short of insolvency.
- However, the courts have not explained what this state would actually encompass.
- Notably courts have refused to be specific, e.g., the New South Wales Court of Appeal in *Linton v Telnet Pty Ltd* said that when directors should pay attention to the interests of creditors was dependent on the facts [1999[NSWCA 33; (1999) 30 ACSR 465.

- The main issue is ascertaining at what point of time before insolvency occurs, that directors are obliged to act in the interests of creditors that needs to be examined.
- No decision has categorically stated when the obligation of directors is triggered.
- Courts have generally failed to be both consistent and precise

WHAT WOULD A CLAIMANT BE OBLIGED TO ESTABLISH?

- Reference is likely to be had to the test that is likely to apply under s.172(1) and which follows the test that applied to the duty to act bona fide for the best interests of the company (*Re Smith & Fawcett Ltd* [1942] Ch 304)
- Case law has provided that s.172(1) essentially provides the same duty (*Re West Coast Capital (LIOS) Ltd* [2008] CSOH 72; *Cobden Investments Ltd v RWM Langport Ltd* [2008] EWHC 2810 (Ch)).

- It is possible that when a director is subject to the duty in s.172(3) the same test that is used for s.172(1) will be applied with the appropriate modification for creditors.
- This is supported by the judgment of Leslie Kosmin QC (sitting as a deputy judge of the High Court) in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*[2002] EWHC 2748 (Ch); [2003] BCC 885 at [87].

- According to this case, if directors fail to take into account creditor interests when they should have done so, then the test provided for in the case of *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62.should be applied with the appropriate modifications for creditors.
- First, in *Charterbridge* Pennycuick J said that where the director against whom proceedings have been initiated had actually failed to consider whether the action that is the subject of complaint would be in the interests of the company, the court had to ask whether an intelligent and honest man in the position of a director of the company involved, could, in the whole of the circumstances, have reasonably believed that the transaction was for the benefit of the company.

- If directors failed to consider creditors' interests when under the duty provided for in s.172(3) then to ascertain whether they are liable the court is to ask whether an intelligent and honest person in the position of the directors, could, in the whole of the circumstances, have reasonably believed that the action that is impugned was for the benefit of the creditors.

- Second, under *Charterbridge* directors could be held liable if the judge disbelieves the directors if they assert that they acted in the good faith belief that what they did was designed to promote the success of the company for the benefit of members.
- Similarly, a claimant might ask a judge to disbelieve a director who maintains that he or she acted, in good faith, in the interests of the creditors.

ONE FURTHER ISSUE

- It is quite possible that companies might move in and out of insolvency or in and out of financial distress over a period time
- Difficulty for directors is knowing whether they are subject to the s.172(1) duty or the s.172(3) duty.
- If in doubt the wise thing to do might be act in the interests of creditors
  - Unlikely that shareholders will bring a derivative action
  - If company enters administration or liquidation the office-holder is more likely to bring proceedings

WHOSE INTERESTS TO BE CONSIDERED?

- It is the creditors as a class, and not a particular creditor or group of creditors : *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch) at [168].

STANDING

- The duty is owed to the company (s.170) so creditors are not able to bring proceedings individually.
- Shareholders are not likely to seek permission to continue derivative proceedings
- The only likely claimants will be a liquidator or administrator

- Section 172 overall is clearly seeking to achieve a reasonable balance between reducing the risk that creditors will not get paid and promoting the success of the company for the benefit of its members.

CONCLUSION

- It is probable that any claimant is going to be a little more (or a lot more) circumspect when determining whether to take legal proceedings if all that can be established is that directors did not act in creditors' interests when the company was in some form of financial difficulty that was short of insolvency.
- Where insolvency at the appropriate point can be established then a claimant might be more bold