Insolvency Seminar

Speaking Notes

- James has discussed a number of proposed reforms to improve the insolvency regime
- Lacuna in the proposals mooted to date is taking steps to resolve considerable uncertainty surrounding when and to what extent directors owe duties to creditors when companies are in financial difficulties
- There is also the further question not yet considered in any detail in the case law as to whether or not shadow directors may owe such duties and, if so, in what circumstances
- This, again, is an area of great uncertainty given that the law remains unclear as to the scope of shadow directors fiduciary duties even in the context of <u>solvent</u> companies
- Do not pretend to have all of the answers but will suggest some ways in which greater clarity might be achieved, along with a degree of consistency with analogous areas of law, and especially the wrongful trading provisions under IA1986

SLIDE 1 ORDER OF PLAY

- ***The interests of creditors in an insolvent company***
    - Start with what is clear: the equation of the interests of a company with those of creditors where a company is actually insolvent or in an insolvency process
- ***When will / should duties to creditors arise in circumstances short of insolvency?***
    - Move on to the much more difficult and uncertain question of when such duties arise in circumstances short of insolvency
    - Suggest that it may be instructive to draw upon the learning that has developed over the last 32 years in relation to wrongful trading
- ***What do / should such duties entail?***
    - Then look at what the duties in fact entail and whether creditors interests become paramount or are to be considered along with those of shareholders
- ***The position of secured creditors***

- Conclude by looking at whether secured creditors' interests are also to be taken into account and then offer some thoughts about the duties that shadow directors may owe: at this stage may be so bold as to encourage views from my colleagues and the floor

- ***The position of shadow directors***

SLIDE 2 STATUTORY DUTY

- May be useful to have a quick directors duties 101 to set the scene
- Under s.172 CA 2006 directors must:

- ***To act in ways in which directors consider, in good faith, would be most likely to promote the success of the company***
- ***Must have regard to long term consequences, employees, suppliers, customers, environment, community, acting fairly between members etc.***
  - While CA 2006 was a codifying statute, purpose of listing these factors was to encourage directors to adopt a more holistic approach to business
- Despite spelling these matters out, glaring omission in the list is the duties of creditors
- As to this, the CA2006 contains:
- ***No specific guidance as to when, and to what extent, must have regard to interests of creditors: existing enactments/rules of law are preserved (s.172(3))***
  - Company Law Review which led to the CA2006 considered adding a statutory definition of when the duty arose and what it entailed
  - Noted that case law was developing and felt might be overkill given the existence of s.214 IA 1986
  - Should note in passing that we now also have s.246ZB IA 1986 covering the position in administrations
  - Biggest risk is chilling effect on entrepreneurialism and creating an over-willingness on the part of directors to place a company into liquidation:
  - Will revisit that topic in discussion of what duty entails later

SLIDE 3 CREDITORS' INTERESTS IN INSOLVENT COMPANIES

- I said we would start with what is clear: need go no further than *Bilta* where Lord Neuberger's adopted of Chief Justice Street's description of the interests of creditors in insolvency

"In a solvent company the proprietary interests of the shareholders entitle them as the general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But ***where a company is insolvent the interests of the creditors intrude.*** *They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets.* ***It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors*** *…"*

(*Per* Street CJ in *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722 at 730 quoted with approval by Lord Neuberger in *Bilta (UK) Ltd v Nazir* [2016] AC 1 at [123])

SLIDE 4

- This is not a talk on the definition of "insolvency"
- However it might help to bear in mind the test under s.123 IA 1986 for what follows

- ***Statutory test under IA1986, s.123:***
  - ***Company unable to pay debts on balance of probabilities without incurring further debt***
  - ***Cash flow test includes debts falling due in reasonably near future Re Cheyne Finance plc [2008] 1 BCLC 741***
  - ***Balance sheet test:***
    - ***Whether present, future, contingent and prospective liabilities exceed assets***
    - ***To be used where cannot foresee with any reasonable degree of certainty what lies within the reasonably near future Re Eurosail [2013] 1 WLR 1408***

- Concepts with which we are all familiar

- On paper they sound straightforward

- However, their practical application is more difficult…

    - Complex questions can arise in relation to degree of discount to be afforded to contingent liabilities and whether prospective liabilities are sufficiently certain to be taken into account

    - Fact sensitive question what is *"reasonably near future"*

- The fact that there is uncertainty about whether or not a company is actually insolvent makes it even more difficult to define what circumstances short of insolvency will suffice for creditor's interests to intrude and for directors to owe duties to them

SLIDE 5

Various attempts have been made:

- ***Company in a "dangerous" or "precarious financial position"***
  (Facia Footwear v Hinchcliffe [1998] 1 BCLC 218 at 228b; Re MDA Investment Management Ltd [2004] 1 BCLC 217 at [75]))

- ***"…doubtfully solvent"***
  (Nourse LJ in Brady v Brady [1987] 3 BCC 535 at 552)

- ***"…bordering on insolvency"***
  (Lord Toulson in Bilta (supra))

- ***"…real and not remote risk of insolvency"***
  (Kalis Enterprises Pty Ltd v Baloglow [2007] NSWCA 191 at [162]; Re HLC Environmental Projects Ltd [2014] BCC 337)

- Worth pausing to look in more detail at "real and not remote risk" test in HLC

- John Randall QC sitting as a deputy high court judge recited the tests set out tests of the company being doubtfully solvent in *Brady* and of its finances being in a dangerous or precarious position in *Facia*

- He also noted the "verge of insolvency" language we will look at in a moment together with the Australian case of Kalis where the language of "real and not remote risk" was used

- The deputy judge concluded *"I do not detect any difference in principle behind these varying verbal formulations"*.

- He regarded as each as a way of trying to say that *"directors are not free to take action which puts at real (as opposed to remote) risk the creditors' prospects of being paid, without first having considered their interests rather than those of the company and its shareholders"*
- He concluded that *"different verbal formulations may fit more comfortably with different factual circumstances"*

SLIDE 6

- Rose J <u>did</u> think that the varying verbal formulations made a difference and that the "verge of insolvency" test was markedly different to the real but more than remote risk test:
- ***"To say that my house is on the verge of burning down seems to me to describe a much more worrying situation compared to one in which there is a risk which is something more than a remote risk of my house burning down" (BTI at [477])***
- ***"The essence of the test is that the directors ought in their conduct of the company's business to be anticipating the insolvency of the company because, when it occurs, the creditors have a greater claim to the assets of the company than the shareholders" (BTI at [478])***
- Distinction between the real and not remote test, and the verge of insolvency test, was particularly material on the facts of BTI:
    - dividend paid to sole shareholder in circumstances where it was alleged the directors ought to have regard to the interests of a creditor to whom the co had given an indemnity for US environmental clean up costs
    - Breach was said to consist of failing to take account of real risk that the long-term liability might have been larger than the provision made before paying the dividend
    - Balance sheet showed no deficit of liabilities over assets and no unpaid creditors: might have been a real and not remote risk of co not being able to pay this but certainly not on the verge of insolvency!
    - Fact that it involved a dividend cf. retaining capital for a contingent liability shows stark contrast between interests of creditors and those of shareholder
    - There was a real possibility that co would never become insolvent:

    - The estimate could well have been correct
    - Conversely the effect of having to operate as if the financial risk was higher would have paralysed ability of company to trade
    - Rose J noted that different considerations might obtain if the provision for the liability was not appropriate but in BTI there no suggestion that this was the case
- Verge of insolvency language has been followed in subsequent cases:
- ***“…on the verge of insolvency”*** ***(BTI 2014 LLC v Sequana SC [2016] EWHC 1686 (Ch); Dickinson v NAL Realisations [2017] EWHC 28 at [113]-[121]; Singularis Holdings Ltd v Daiwa Capital Markets Europe Ltd [2017] EWHC 257 (Ch) at [137]; Burnden Holdings (UK) Limited v Fielding [2017] EWHC 2118 (Ch); SoS v Akbar [2017] EWHC 2856 (Ch) at [92]-[94]***
- Worth looking at a few in slightly greater detail
- In *Dickinson* HHJ Cooke was faced with a similar situation to that which had been pertained in *BTI*
    - Involved a buy back of shares at a time when there was a risk that an aluminium company might receive a claim for an environmental clean up operation was not a breach of duty:
    - Applying the verge of insolvency test, HHJ Cooke held that the potential for a claim did not mean that directors had come to owe their duties to creditors of the company
- Can contrast with *Singularis*
    - Rose J applied her own guidance in holding that Singularis was on the verge of insolvency when it owed £238m and its only means of payment was an injuenction of funds from a director whose assets had been frozen
    - As a result the defendant director was in breach of fiduciary duty in making payments to other group companies
    - Further, he could not ratify such breach despite being the sole shareholder because of the company’s insolvency

SLIDE 7

- The verge of insolvency test came to be considered by LB Marshall in her epic judgment in Carlyle Capital Corporation v Conway & Ors.
- Despite very substantial legal costs, months of trial, extensive expert and factual evidence and a judgment in excess of 500 pages the facts of the case may be stated quite simply.
- CCC was a Guernsey fund with the majority of its assets invested in residential mortgage backed securities. Equity was approximately $1bn leveraged 36x with repo finance. The aim was to provide Carlyle private equity clients with a safe harbour for their capital achieved via investments in securities backed by the mortgage agencies Fannie Mae and Freddie Mac which nevertheless enjoyed substantial returns because of the degree of leverage
- The only real risks associated with the fund were liquidity and the collapse of the residential mortgage industry.
- All would therefore had been well had it not made the majority of its investments following an IPO in June 2007, thereby setting sail just as the storms associated with the credit crunch arrived.
- The plaintiff liquidators did not challenge the initial business model, but advanced claims based upon multifarious causes of action, each of which essentially alleged that the directors should have recognised that they could not weather the storms and ought to have deleveraged or wound up the fund at various points between July 2007 and March 2008 when the fund ultimately collapsed.
- In holding that CCC was not on the verge of insolvency during these periods, and therefore that the directors had not come to owe their duties to creditors LB marshall endorsed the views of Rose J and held that:

• **The *"verge of insolvency"* test conveys an *"appropriate sense of imminence"***

She also commended the fact that

• **It is a flexible and fact dependent test which requires regard to be had to:**

> ***"…to the particular nature of the business, the state of the company's balance sheet and all the overall circumstances."***

(*per* Marshall LB in *Carlyle Capital Corporation Limited v Conway & Ors* (Royal Court of Guernsey) (Judgment 38/2017l 4/9/17 at [440]-[443])

SLIDE 8

- May be a flexible and fact specific test: but practitioners might be forgiven for wanting something a little more concrete…
- This is especially so where we have a test from the wrongful trading context in relation to which there is a very substantial degree of learning and practical applicaiton
- This is the threshold ***Requirement that defendant director "knew or ought to have known that there was no reasonable prospect that the company would avoid entering insolvent liquidation/administration" (ss.214(2) and 246ZB(2))***
- This expresses the degree of imminence by reference to there being no reasonable prospect of avoiding an insolvency process ***Cf. company being factually on verge of insolvency***
- It also brings into play the directors' state of mind, albeit holding them to an objective standard by reference to what they ought to have known as well as what they in fact knew
- The other element of liability is the requirement that:
- ***Under ss.214/246ZB director with requisite knowledge is obliged to show every step was taken with a view to minimizing potential loss to creditors (ss.214(3)/246ZB(3))***
- As I will discuss in a moment, this may be contrasted with the fiduciary duty to act in what a director subjectively believes in good faith to be the best interests of the company ***Cf. subjective fiduciary duty / Charterbridge test***

SLIDE 9

- From the CLR final report it may be seen that a test with parallels to the wrongful trading principles was in fact mooted:
- ***CLR Final Report: Actual or constructive knowledge of a substantial probability of an insolvent liquidation (para. 3.17)***
- Slightly oddly this the model clause proposed at the same time was somewhat different: ***Cf. CLR Model Clause: "knows or would know but for a failure of his duty to exercise due care and skill, that it is more likely than not that the company will at some point be unable to pay its debts as they fall due"***
- ***Alternative: adopt focus on insolvent liquidation but abandon requirement to show actual or constructive knowledge***

- Remains to be seen whether the common law will develop from the verge of insolvency test or statute will intervene.
- In my view there would be considerable benefits in having the same focus in both areas and expressing the directors duties test by reference to whether or not there is any reasonable prospect of avoiding an insolvent liquidation
  - Have a great deal of learning on this
  - Insolvency practitioners likely to be advising on wrongful trading and duties of directors at same time – therefore makes sense to have a similar test
  - The cases applying the wrongful trading test have been carefully calibrated over the years to try to avoid forcing directors precipitously to place companies into liquidation and enable them to take some risks in trying to trade back to profitability
- May not be necessary to import an additional focus on the directors' state of mind so as to show that they knew or ought to have known this
- In wrongful trading the hurdle needs to be set this high because directors then come under a duty to take all reasonable steps to protect the interests of creditors
- In the directors duties context the standard to which directors are held is substantially lower than this: it is to these duties that we now turn

SLIDE 10

- ***The duty remains subjective even when owed to creditors***
- ***HOWEVER***
- ***"…the subjective test only applies where there is evidence of actual consideration of the best interests of the company. Where there is no such evidence, the proper test is objective, namely whether an intelligent and honest man in the position of a director of the company concerned could, in the circumstances, have reasonably believed that the transaction was for the benefit of the company" (per John Randall QC in HLC Environmental Projects Ltd applying the principles first established in the context of solvent companies in Charterbridge Corpn Ltd v Lloyds Bank [1970] Ch 62 at 74E-F)***
- John Randall QC went on to state that a failure to consider creditors' interests might include overlooking the interests of one particularly large creditor

- Failing to take into account a material factor goes to the validity of the director's decision making process

SLIDE 11

- So much for the standard to which directors will be held**.**
- A more difficult question is what weight is to be given to creditors' interests
- It should be remembered that:
- ***Creditors interests must always be considered even in solvent companies (Winkworth v Baron Developments Ltd [1986] 1 WLR 1512; Brady (supra) at 40G-H; LRH Services Ltd v Trew [2018] EWHC 600 (Ch))***

- *LRH v Trew*
    - HHJ Cooke noted that the duty is owed to promote the interests of the company for the benefit of the members, not the benefit of the members directly, and is promotion of interests of members as a whole
    - This is not mutually exclusive with having regard to the interests of the creditors as if the company does not pay its creditors it will have to cease trading and there will be no profits to distribute mong the members
    - Also in interests of members to have a surplus of assets in a winding up [29-30]

HOWEVER

- Where risk of creditors not being paid on time their interests will trump those of members who take this risk as part of deal with the company
- ***Divergence of approaches in verge of insolvency context:***
    - ***Creditors' interests become paramount (Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd [2003] 2 BCLC 153 at [74] drawing upon Brady and Kinsela)***
    - ***Creditors' interests are the most important consideration but shareholders' interests may still be taken into account (Ultraframe (UK Limited v Fielding [2005] EWHC 1638 at [1304])***
    - ***Sliding scale depending on degree of financial difficulty (The Bell Group v Westpac Banking Corp [2008] WASC 239 at 4419; Carlyle at [452])***

- Worth noting that cases saying creditors interests are paramount were ones in which the company was in fact insolvent at time of trial cf. verging on insolvency
- Key to understanding what paramountcy means prior to actual insolvency requires looking at what the interests of creditors/shareholders are
    - Shareholders will be interested in value of shares, dividends and ongoing profitable trading of the company
    - Creditors want to be paid on time
    - If company can trade profitably and have a surplus of assets over liabilities their interests are aligned: even on winding up they will have same interest as shareholders will want to share in the surplus
    - Difficult issue arises when there is not going to be a surplus and creditors will take less than 100p in the £
    - It is in this scenario that there interests are paramount as they are the only financially relevant interests
    - HOWEVER if there is more than one way of serving the creditors' interests and one of the routes carries a greater prospect of the shareholders receiving some form of benefit at the end, directors would in my view be required to take that latter route – *classic case is where believe that trading on will result in creditors being paid in full and surplus for shareholders as compared with liquidation which might realise 100p in £ but also carries risks –* ***will see in a moment that courts are sympathetic to this dilemma***

SLIDE 12

- In Carlyle LB Marshall carefully considered the cases referred to above discussing the degree to which creditors interests are to outweigh those of shareholders
- She feared that it would have an unduly chilling effect on directors' willingness to take risk if it was automatically the case that creditors' interests as automatically paramount
    - ***"…the English line of authority which proposes that the interests of creditors become "paramount" over-states the true position. Even in English law, on closer review, there is a more fluid and fact-dependent approach than is implied by the absolutist connotations of the word "paramount" (Carlyle at [452])***

- ***"The directors' duty to act in the best interests of the company extends to embrace the interests of its creditors , and requires giving precedence to those interests where that is necessary, in the particular circumstances of the case, to give proper recognition to the fact that the creditors will have priority of interest in the assets of the company over its shareholders if a subsequent winding up takes place" (Carlyle at [455])***

SLIDE 13

- What, then, does this mean in practice:
- ***Clear cut cases: excessive payments to directors; preferences; unlawful distributions etc.***

  Official Receiver v Stern [2002] 1 BCLC 119 at [51]-[54]; Vivendi (supra); GHLM Trading Ltd v Maroo [2012] 2 BCLC 369 at [168]-[169]; HLC Environmental (supra)

Worth pausing to note that in the sphere of preferences it was held in GHLM that there could be a breach of the duties owed by directors to creditors even if the technical preference requirements of the IA1986 were not satisfied.

- o Just as directors have a duty to treat members equally, if act to advance the interests of a particular creditor without believing will aid all creditors, this may be a breach of fiduciary duty where a company is in financial difficulties
- o That said, it should be borne in mind that even there is a breach of fiduciary duty in this context, theremay well be no loss to company as effect will just be to discharge a debt: can render transaction voidable

- ***Decisions to continue to trade are particularly difficult (as in wrongful trading context)***

  Re Continental Assurance of London [2001] BPIR 733 at [106]-[108]; Facia Footwear (supra); Re Ralls Builders Ltd [2016] Bus LR 555 at [168]-[179]; Carlyle at [458]

- An immediate cessation of trading may result in fire sales, especially if assets have been purchased using debt finance:

    - This was an issue to which a huge amount of expert evidence was directed in Carlyle with dramatic references being made by the Defendant's experts to the "liquidity death spiral" that would ensue from a rapid deleveraging of assets

- Courts have therefore been willing to allow the directors to take some degree of risk in trading on where honestly believe that there is a reasonable chance of succeeding and enabling creditors to receive 100p in the £
- LB Marshall in Carlyle went on to hold that this might justify directors in trading on where they believed there was a reasonable chance of achieving a surplus (and therefore benefiting shareholders as well) even if it could be said that from a creditors' perspective the safest (albeit less profitable) route would be immediately to liquidate the company
- Ultimately this is a fact specific question and in the view of LB Marshall the more parlous the financial state of the company, the greater the weight that needs to be accorded to what is in the interests of creditors.

SLIDE 14

- Practical guidance likely to be similar to that given to directors where there is a risk of wrongful trading liability:
    - ***Taking advice and holding regular well documented meetings where creditors' interests are discussed and reasons for decisions are stated***
    - ***Consideration of working capital requirements in respect of future debts***
    - ***Considering steps to improve liquidity (although n.b. risks of fire sales – <u>Carlyle expert evidence on this…</u>)***
    - ***Initiating insolvency proceedings where cannot trade through difficulties and will lead to better result***

SLIDE 15 SECURED CREDITORS

- ***Carlyle strongly suggest secured creditors will not be owed the same duties as unsecured creditors:***
- ***"…this follows from the very reason for the interests of the "company's creditors" coming to the fore, namely that because it is in a parlous state, the company is***

trading at the risk of its creditors not getting paid. It is therefore the creditors who are at such risk whose interests are to be protected, and they are the unsecured creditors. Secured creditors - at any rate those with fixed security - are not at the same risk as unsecured creditors. They have first call on their security whatever risks or actions the company takes and they have a degree of control through whatever powers of realisation their security confers on them. This is the benefit as against unsecured creditors for which they have bargained, but it means that their interests are fully protected by their security as long as it is adequate. This security is not being risked whether the company continues trading or does not…" (Carlyle at [463])

SLIDE 16

- ***Case law as to whether and to what extent shadow directors owe fiduciary duties remains uncertain (Ultraframe at [1289] per Lewison J; Vivendi (supra) per Newey J; Sukhoruchkin v Van Bekestein [2014] EWCA Civ 399)***
  - Lewison J's view was that the mere fact that someone was a shadow director would not lead to them owing fiduciary duties, and that it would need to be shown in any given case that the activities of the shadow director had gone beyond indirect influence so as to give rise to fiduciary obligations
  - Newey J: shadow directors ought typically to owe fiduciary duties, at least in relation to the directions or instructions that they give because they should be expected to act in the best interests of the company in these circumstances
- ***Power to make regulations under Small Business Enterprise and Employment Act 2015, s.8 has not been exercised***
- ***No clarity provided by provision in CA2006, s.170(5) that the duties under CA2006, ss.170-177 apply "where and to the extent that they are so capable of so applying"***
- ***Morgan J has advocated a more fact sensitive approach looking at whether fiduciary duties should be imposed upon an individual cf. seeking to adumbrate the duties that shadow directors should always be under (IAP v Rosser & Ors [2018] EWHC 756 at [259]-[275])***
  - Court should be entitled to conclude that a person is subject to all or only some fiduciary duties, and that such duties may be modified, for example to allow some degree of self-interested action

  - The question in each case is whether the relevant person undertook expressly or by implication a fiduciary obligation

- Having regard to these principles it would appear that the mere fact that a company is on the verge of insolvency would suffice to transmogrify the duties of a shadow director so that they are automatically owed to creditors rather than shareholders

- On Morgan J’s test one would need to look at what the individual in question had expressly or impliedly undertaken by way of fiduciary obligation and to whom

- It may therefore be that a shadow director ought only to owe fiduciary duties to creditors when it can be shown that he or she did know, or ought to have known, that the company was on the verge of insolvency and indirectly influenced the *de jure* directors to act in a way which affected the interests of creditors

- ***I’m sure this will be a question on which views differ. First ask my colleagues what they think and then throw open to the floor.***