

PERSONAL GUARANTEES AND DIRECTORS LIABILITIES ON INSOLVENCY

WHAT SCOPE FOR HOUDINI ?

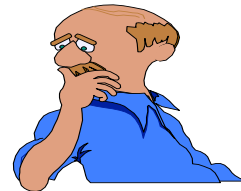
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CAUTIONARY OBLIGATIONS

The Structure



X
Creditor



Y
Principal Debtor



Z
Cautioner

The obligation of a cautioner is not an independent obligation , but is essentially conditional in its nature , being properly exigible only on the failure of the principle debtor to pay at the maturity of his obligation”

Lord Ross: City of Glasgow District Council v Excess Insurance (1986SLT 585)

Similar transactions ?

an insurance or indemnity contract does not depend on a principal contract- so not a guarantee.

The concept is getting wider – cautionary obligations may arise “ in the broad sense” where X grants a Standard Security of the debts of Y (**Hewitt v Williamson 1998 SCLR 601**) “ In security of the whole obligations to pay all sums...due by W ”

“ The concept of cautioner and cautionary may be invoked in relation to any circumstance in which A exposes himself or his property in security of the debts of B to C”

Braithwaite v Bank of Scotland 1999 SLT 25

Quasi cautionary obligations involve the duty of Good Faith but do not give rise to obligations of the cautionary to become personally liable for the principal debtors obligations beyond the Standard Security. This obligation owed by cautioners “ in the narrow sense” does not involve the special rules such as the release of the cautionary by an alteration in the principal obligation.

Any Special Form for Cautionary Obligations ?

No general requirement for writing

But.....

- 1) A gratuitous unilateral obligation not undertaken in the course of business Requirements of writing (Scotland) Act 1995 S 1(2) a ii requires Writing and Subscription of the Cautioner
- 2) Consumer Credit Act 1974 – in the case of a Regulated Agreement
Guarantee in Writing + Executed
Also copies & statutory requirements

Main Defences

1. Acts or Omissions by Creditor

Normal Contractual Defences

a) Induced by Creditor’s Misrepresentation

The mis representation must be material AND induce the cautioner to contract

- A cautioner who knows of the truth cannot claim misrepresentation

Not a contract Uberimae Fides – but not quite the normal situation either.

If the circumstances are unusual between the Debtor and Creditor and not to be reasonably expected there is a duty to disclose.

Lots of cases which suggest that if Creditor is aware that cautioner is under a misapprehension he must disclose his true position – Answer any questions truthfully and fully but no general duty to volunteer information. Perhaps there is a duty to answer any question which is specifically put.

b) Undue Influence

c) Force and Fear

d) Facility and Circumvention

e) Essential Error

2) ACTS AND OMISSIONS BY DEBTOR

The developing Law

The traditional Scots Law position was that the debtor's misrepresentation , undue influence etc has no effect .

- the contract is between the Creditor and Cautionary unless the creditor uses the debtor as his agent or is aware of the misrepresentation etc.(Young v Clydesdale Bank (1899)17R 231 But this is steadily being eroded by case law and is may now be doubtful.

Can the Creditor enforce the Guarantee where the debtor has been fraudulent and Creditor has grounds to suspect fraud ?

Where no reasonable suspicion of fraud on the part of the Debtor , the Creditor would require to have given valuable consideration to enforce the guarantee.

Where the misrepresentation is fraudulent the creditor cannot enforce the guarantee where a reasonable person would have expected that fraud had occurred.(see Smith v Bank of Scotland 1997 SLT 1061 : Owen and Gutch v Homan (1853) 4 HLC 997.

Also, where force or fear was involved there can be no consent and the transaction is void (see Trustee savings Bank v Balloch 1983 SLT 240).

The present Position

All the above restrictions on the rights of Creditors to enforce apply but the position has been extended and rationalised by The Duty Of Good Faith developed by Lord Clyde in Smith v Bank of Scotland 1997 SLT 1061 – which followed the

English case Barclays Bank v O'Brian. So where the duty arises the Creditor must act in good faith to the Cautioner as well .

But

changes are confined to where a reasonable man might conclude that because of the personal relationship between the Cautioner and Principal Debtor, the Cautioner's consent might not be freely given.

And

an "actionable wrong" must have taken place before the guarantee may be impinged (Royal Bank of Scotland v Wilson 2004 SC 153).

So

in the great majority of cases where a Director guarantees the debts of a Company no change has been made.

"The concept of good faith is used in the sense that a party may not be entitled to enforce his apparent rights because he is aware of or is put on inquiry to discover some prior vitiating factor . The existence in fact of such a factor is a prerequisite to the applicability of that concept."

Lord Hamilton Braithwaite v Bank of Scotland 1999 SLT 25

Looking at the new rules in practice

The new regime only applies "a close personal relationship"

Parent child wife husband lover etc.

Including technically different situations like family companies

The requirement disappears where obligation is also for Cautioners benefit

Husband and wife jointly agree to guarantee a loan to them both (Ahmed v Clydesdale Bank 2001 SLT 423

Mother also has interest in company managed by son (Wright v Cotias Investments 2000SCLR 324 . A co-extensive obligation from the Principal Debtor meant that the guarantee was not gratuitous (RBS v Wilson supra)

Has there been an Actionable Wrong by the Debtor ?

Where misrepresentation or undue influence or anything which in the general law could amount to an actionable wrong- the courts now examine the situation to determine whether there has been a failure by creditor to observe duties of Good faith towards the Debtor.

eg. The Creditor must not mislead by omission

Correct manifest misapprehensions

Rectify Misapprehensions by Cautioner which are known

Require Cautioner to obtain legal advice

The Lack of Good Faith must result in lack of consent by cautioner

The consent of the Cautioner must have been compromised – the standard may be that the circumstances are sufficient to amount to a defence were the if action by Debtor Cautioner must be able to say " but for this Cautioner would not have entered into the transaction"

USUALLY the “ Good Faith” requirement is fulfilled because a Banks Standard Procedures is to require Cautioners to obtain Independent Legal Advice.

So in practice since Smith Financial Institutions require separate advice for guarantors and make the loan on conditions which satisfy Good Faith Requirements.

3) THE PRESSURE POINTS

The Banks systems are only as good as their back office.

Check the custom made parts of the Document

Names

Addresses

Dates

Where witnessed

– **but** a cautionary obligation does not need to be holograph or attested

Braithwaite v Bank of Scotland (1999 SLT 25), s6 Mercantile Law Amendment Act (Scotland) 1856 . Anyway where required eg standard security

A debtor may be personally bared from relying on a defective citation:

Forsyth v Royal Bank of Scotland 2000 SLT 1295

Construction of Cautionary Obligations

What is the true intention of the parties?

Look at everything including the context ?

Investors Compensation Scheme v West Bromwich Building Society (1998) 1WLR 896.

“ the factual matrix and in particular the transactional context of the guarantee”
(Waydale v DHL Holdings (UK) Ltd No 2 2001 SLT 207 per Lord Hamilton 232)

The traditional rules of Construction are still important. Guarantees are normally pre-eminently one sided documents to be referred to again and again in different contexts so traditional rules of constructions will be referred to eg. to resolve an ambiguity contra Proferentem and that the document creating the obligation is read as a whole.

For example:

A guarantees B’s debts up to £1,000. The construction is that that is entire so If B borrows £ 1500 A is liable for £1000 and no more.

So, if B pays back £1,000 then A is discharged [not still owing £666]
(Bank of Scotland v MacLeod 1986 SLT 504)

4) The Rights of Cautioners

All excluded in the well drafted Guarantee

a) The Benefit of Discussion

Creditor proceeds against Debtor first .

Excluded by 1.2

b) Relief

The cautioner may call upon the Debtor to relieve him of liability
_even where the debt is not due

The cautioner may demand that the debtor pays the debt or himself
pay and obtain recourse against the Debtor – Excluded by 5.1.2

c) Assignment and Sharing in Securities

Where the Cautioner has paid the principal debt in full he may demand an
Assignment of the debt as well as any security for it or diligence done.

Excluded by 4.2

d) Ranking in Bankruptcy

If the creditor pays in full he is entitled to rank on the bankrupt estate of
the principle debtor.

However both the Creditor and Cautionary may have lost but both
cannot rank. If the creditor has ranked on the principle debtor's estate
and obtained payment from the cautioner the cautioner cannot rank.
Complicated situations arise where there are limits on the level of
Guarantee.

Postponed by 5.1.2

e) Release on Discharge of Principal Debtor or Novation

Where a principal debtor is released from the obligation by the creditor
without the creditor's consent.

Watch out for the pactum de non petendo which is an agreement
by the creditor only not to sue rather than a discharge.

Excluded by 4.2.8 & 9

e **But** surely even an exclusion clause would not sanction an extreme
exercise of Novation? cf. De Montfort Insurance v Lafferty (1998
SLT 535)

f) Compensation or Set-Off between Creditor and Cautioner or Creditor and Debtor

Postponed by 8

But hugely complicated with conflicting claims and rights

g) The Rule in Clayton's Case

F I F O

Where there is a current account or current accounting between the creditor
The earliest credit is set against the earliest debit

Deeley v Lloyds Bank
Overdraft limit of £1000 guaranteed by D. D notified bank no more guarantee. The borrower paid sums in excess of £ 1000 to the bank but borrowed more- F I F O so sums paid wiped out first indebtedness.

Excluded by 6.1

h) Prescription

If the principal debt expires then so does the guarantee
Watch for all the "extras" eg banks legal costs etc.

Like most obligations the guarantee expires after 5 years
From becoming enforceable. Prescription and Limitation (Scotland) Act
s. 6 & Sch. 1 p1 g
- when does it become enforceable ? Complicated question of law & fact

i) Death or Alteration

The death of the Creditor or Debtor releases the Cautioner from future debts but he remains liable for existing debts
The death of the Cautioner makes no difference to the liability.

Partnership Act 1890 s 18
Guarantee of Firms Debts as to future transactions is generally revoked by any change eg new partner, conversion to limited company.

Liquidation of Company as Creditor or Principal Debtor appears to make no difference to Cautioner.

Excluded by 3.1 , 4.2.3

j) Giving Time

Where the Creditor legally disables himself from demanding immediate

Payment from the Principle debtor for a period of time the Cautioner is Released. To qualify the Creditor must legally disable himself, for example by accepting post dated bills of exchange ie not due and payable (C&A Johnstone v Duthie 1892 19R 624)

But there is a grey area regarding Guarantees for a general and unspecific loan of money or for a collective supply of goods rather than for a specific debt of a certain amount or purchase of an item(Calder &Co v Cruikshank’s Trustee ((1899 17 R 74, 80)

But where the Cautioner agrees to give time there is no exemption.

Excluded by 4.1.1

k) Alteration of Principal Debt

Any alteration of the contract between the creditor and principal debtor without the cautioners consent releases the debtor.

For example an increase or reduction in repayments (Napier v Crosbie 1964 SLT 185)

Part Excluded by 1.1.1

Part Excluded by 6

Part Excluded by 4

l) Discharging a Co Cautioner

Seems obvious but apparently the rule only extends to joint co- cautioners not to those who have guaranteed separate sums.

Excluded by 4

m) Giving up Securities

Seems obvious – thought also to apply to a requirement on Creditor to make a security effectual

But may not apply to a failure to make a security effectual (Bank of Ireland v Morton (No 2) 2003 SC 257)

Excluded by 5

5) Burden of Proof and Presumptions in Undue Influence Cases

There are cases where the facts raise a prima facie inference of abuse of trust

- where the facts cry out for an explanation. (Honeyman ‘s Exrs v Sharp approved in Smith) – a cousin of Res Ipsa Loquiter

THE LIABILITIES OF DIRECTORS ON INSOLVENCY

INTRODUCTION

Measures permitting Company Directors to become liable for acts and omissions are on the increase. Health and Safety , Environmental Protection and Obligations to Members join Insolvency as being areas where significant inroads to the protection afforded by limited Liability are increasingly to be found. Having lost their preferential creditor status with the introduction of Enterprise Act 2000, HM Revenue and Customs may increasingly flex their muscles in the direction of proceedings against Directors.

For the first time United Kingdom legislation has enshrined the fundamental duties of directors in section 172(1) Companies Act 2006. This supplements the common law duty to act in the best interests of the Company as follows:

172(1) A director of a company must act in a way that he considers , in good faith , would be most likely to promote the success of the company for the benefit of its members as a whole , and in doing so have regard (amongst other matters) to –

(a) The likely consequences of any decision in the long term

(b) the interests of the company's employees

(c) the need to foster the company's business relationships with suppliers , customers and others

(d) the impact of the company's operations on the community and the environment

(e) the desirability of the company maintaining a reputation for high standards of business conduct,

(f) the need to act fairly between members of the company.

Later sections contain more specific duties: To act within powers , promote the success of the company , exercise an independent judgment , exercise care skill and diligence, avoid conflicts of interest not to accept benefits from third parties and to declare interests.

Another duty to weigh into balance is that of that of the Insolvency Practitioner. The role is not simply a private duty to creditors- they have a "public interest function" . The law of winding up has always had a dual purpose:

(i) To facilitate the collection and realisation of the company's assets and the orderly settlement of it's liabilities .

(2) The investigation of the company's affairs and imposition in the public interest of criminal or civil sanctions on wrongdoers , in particular , on company directors found to

have abused the privilege of limited liability.[Re Pantmaenog Timber Co Ltd , Official Receiver v Wadge Rapps and Hunt [2004]1 AC 158 HL.]

PRINCIPAL AREAS of LIABILITY

1). Section 212 Insolvency Act 1986 – The Summary Remedy against Misfeasance

If in the course of a winding up it appears an officer of a company, liquidator, administrative receiver or promoter who has misapplied, retained or become accountable for any money or other property of the company or has been guilty of any misfeasance or breach of fiduciary or other duty in relation to the company may be required to repay, restore or account or otherwise provide compensation.

An illustration of a breached fiduciary duty is *MacPherson v European Strategic Bureau Ltd* (2000) 2 BCLC in which the directors came to an agreement with the insolvent company that they would be paid receipts from current contracts as payment of consultancy services to the company. The effect was a distribution to shareholders without making provision for current and future liabilities. It was also in breach of the statutory rule against making a distribution to members of assets other than profits. Liquidators etc. may also be sued in terms of s 212 (*A&J Fabricators (Batley) Ltd v Grant Thornton* 1999 BCC 807) .

The innovative judicial approach towards finding duties of care and skill on the part of directors may not extend to the Summary Misfeasance remedy. Authorities show the courts are be conscious the existing fiduciary duties of directors are widely drawn. In Regentress Plc (2001BCC 145) [a case on wrongful trading] a claim for clawback against another director had been waived on the basis that he would continue to assist the company , work free of charge and the board would remain united in the face of bank and creditor pressure. These factors combined to provide a clear commercial benefit to the decision which should not be viewed with hindsight. No misfeasance was found though a trustee would probably have been held to have duties to enforce the clawback against a co trustee.

2). Section 213 Insolvency Act 1986 - Fraudulent Trading

Persons who were knowingly parties to the carrying on of a business with intent to defraud creditors of the company or creditors of any other person or with any fraudulent purpose, may be required by the court to make restitution.

3) Section 214 Insolvency Act Wrongful Trading (see later)

214.-(-I) the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.(a) the company has gone into insolvent liquidation.

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time;

4) Section 242 Insolvency Act 1986 – Gratuitous Alienations (Scotland)

A creditor , liquidator , administrator may claim a gratuitous alienation. The period prior to the winding up in which the alienation may be caught depends on the relationship of the recipient - within five years of winding up or making an administrative order in the case of "an associate" or two years in the case of anyone else. A gratuitous alienation may be reduced when at the time or after it was made the company's liabilities were greater than its assets.

- unless adequate consideration “ patrimonial worth at the time given” (Jackson v RBS 2002 SLT 1123 (

5).Section 243 Insolvency Act 1986 - Unfair Preferences

A preference in favour of a creditor to the prejudice of the general body of creditors which is not in the ordinary course of trade or business made earlier than six months before the commencement of winding up or the making of an administrative order may be reduced.

6).Company Directors Disqualification Act 1986 - Disqualification of Delinquent Directors

7) Section 214 Insolvency Act Wrongful Trading in Detail

Originated from Cork Committee's analysis of shortcomings of the existing law by introducing a broader concept of wrongful trading.

Key Provisions

214.-(-I) the court, on the application of the liquidator, may declare that [a]..... person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

(a) the company has gone into insolvent liquidation.

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time;

The Every Step Defence

(3) "the court shall not make a declaration if it is satisfied that that person 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.

Limited Subjectivity

(4)the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by 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.

(5) The reference to the functions carried out by a director includes any functions which he does not carry out but which have been entrusted to him.

“ This test sets an objective minimum standard which obliges all directors to acquire and maintain a basic knowledge of the company’s financial position” “ intelligent laymen” per Park J Re Continental Assurance Co of London (ParkJ 2001 WL 720239)

Debts include Liquidation costs

(b) a company goes into insolvent liquidation .

if 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.

(7) In this section "director" includes a shadow director.

(8) This section is without prejudice to section 213.

Associated Powers of the Court

215.(2) the court may give such further directions as it thinks proper and

(a) provide for the liability of any person under the declaration to be a charge on any debt or obligation due from the company to him, .

(4) may direct that the whole or any part of any debt owed by the company to that person and any interest thereon shall rank in priority after all other debts owed by the company and after any interest on those debts.

General Observations

1. In contrast to other provisions (such as those relating to gratuitous alienations, unfair preferences or misfeasance) only a liquidator has the right to raise proceedings for a contribution in terms of Section 214.

2. Section 214(2)(b) (... at some time before the commencement of the winding up ...) seems to put onus on the liquidator to not only demonstrate that the relevant director knew or should have concluded that an insolvent liquidation was not likely to be avoided but also to identify the date on which that knowledge should have been held or that conclusion formed. However as in some of the English cases , the Sheriff in Dyer v, Hyslop went a considerable way to assist the liquidator by taking the date by which statutory accounts required to be lodged as the date by which the director concerned was deemed to know what the accounts, when ultimately prepared, would show.

3. Section 214 includes a definition of insolvent liquidation which relates the value of assets to the liabilities of the company: including the costs of the winding up. These costs have to be paid by the company. What this means for any company in financial difficulty is that its directors should not rely on balance sheets drawn up under the going concern assumption as a defence against wrongful trading. Rather, they should have regard to what the position would be if the assets were valued on a break-up basis. However, many directors would be guilty of wrongful trading if they were required to value assets under withdrawal of the going concern assumption. This fact which has not been addressed in the legislation undoubtedly creates a tension which can perhaps only be resolved as follows: The liability does not arise unless the insolvent liquidation is foreseeable. In other circumstances the Directors reasonably conclude there was a reasonable prospect of avoiding the company going into insolvent liquidation. So the company's assets may be valued on a going concern basis. If there is no prospect of avoiding insolvent liquidation, the break up value must be applied including the costs of liquidation. How the gap between the two situations which is likely to be considerable is bridged is unknown but in equity cannot be laid at the door of the defender. Although no mention of liquidity is made anywhere in the section, to have sufficient sources of liquidity is in reality the key to avoiding liability under the section.

4. There is an escape route for directors in Section 214(3) often inaccurately referred to as - the "every step" defence. In reality, it is probably impossible for any director to establish every step possible step has been taken. So probably this provision can be interpreted as taking practical and realistic steps to minimise the loss for creditors and if a director fails to take these steps the preconditions for liability under Section 214 are established. Resigning as a director is unlikely to amount to the taking of every step, although if an individual has proposed initiatives to mitigate the creditor's position but finds that his board colleagues :reject those proposals he would be able to resign without the fear of subsequent proceedings for wrongful trading,.A director without a majority cannot by himself put a company into liquidation (see section 124, :Insolvency Act 1986).

5. Section 214(4) is directed to the state of knowledge, skill and experience a given director may possess. It places certain minimum standards of conduct on all directors and places higher standards on directors who, because of their personal experience, standing and reputation are expected to be more capable of managing the affairs of a company. A distinction may be drawn between function and competence. For example, a marketing director is entitled to rely on the financial director to produce accurate accounting information notwithstanding that as between the two, the marketing director may have the greater depth of commercial experience. Directors are entitled to rely upon sources of advice from apparently competent sources (see *Norman & Anr v Theodore Goddard & Ors* (1992 BCC 14).

6. It might also perhaps be argued that the executive directors who are expected to carry out functions which are more onerous than non-executive directors have higher duties because of their greater knowledge of the company's affairs. But non-ex directors are not immune from liability for wrongful trading. They are entitled to rely on the executives but they must be able to show that they subjected the affairs of the company to proper scrutiny and made reasonable enquiry of the director's actions and decisions. However it is " deriliction of duty to acquiesce in dividend decisions which might be inappropriate without actively considering the issues involved in accordance with the obligation to ensure that the company operated on a solvent basis and in accordance with the requirements of the Companies Acts." [or other illegal acts] (*Re AG (Manchester Ltd (In Liquidation)* [2008 BCC 497]

7. By its use of the concept of reasonableness the section imposes an objective standard to determine the minimum commercial standards to be expected of directors. So far as commercial ability and acumen are concerned, the standards to be applied depend upon the particular facts of each case and can only be assessed by extensive reference to the decided cases. So far as the minimum standards of financial awareness are concerned, Parliament has supplied the answers.

DECIDED CASES SHOW THE PROVISIONS IN OPERATION

Gore-Browne notes:

"Precisely how far, indeed, the liability is to extend is very difficult to predict with any confidence: it is not too cynical to suggest that Parliament has delegated the determine the appropriate reach of liability for negligence in the period before insolvency (Gore-Browne: Companies: 35.4.2.).

Re DKG Contractors Limited 1990 BCC 903

The company was incorporated in 1986 to carry on business originated some years before by the principal director as a groundworks sub-contractor. After formation the principal director

continued to employ labourers directly on site and used his own machinery. He then invoiced the company for the labour and machines he had supplied, and became a substantial creditor eg. he paid the company £50 per day for labourers but charged the main contractor £80 per day.

For the first two years of trading the director's personal bank accounts were used by the company. Even after an account was opened by the company, large sums of money continued to be paid to the director's personal account. In the ten months before liquidation £1417,763 of the company's money found its way into the principal director's own account. No statutory accounts were ever prepared. The company held no AGM. The principal's wife (also a director) kept a "black book" contemporaneously showing payments received and outlays made. (The report of the case does not suggest an infringement of Section 22-1 of the Companies Act 1985.)

The company was constantly in financial difficulties and in the last year sixteen creditors obtained judgments against the company.

It was held that the directors should have concluded by the end of April 1988 that there was no reasonable prospect of avoiding a liquidation and were accordingly liable for wrongful trading under Section 214 in respect of trading after that date. By that time the directors received sufficient warning signs e. g. pressing creditors, reluctant suppliers and bailiffs' visits. The judge decided that had the directors "taken stock" at that point, they would have concluded no reasonable prospect existed of avoiding insolvent liquidation.

Re Purpoint limited 1991 BCC 121

In February 1986 the company took over the assets of a failed printing company paying a consideration of £5,000 which was wholly borrowed from a bank. Shortly thereafter the company's assets were increased by adding a printing press and two cars on hire purchase.

No statutory accounts were ever produced and the accounting records of the company were scant. The director admitted in evidence that after December 1986 the company was unable to pay its trade debts as they fell due. Large sums (mainly in cash) were withdrawn by a director and not accounted for in the company's records. Eg. £5,397.35 unrecorded in the company's books.

In May 1987 the company's accountants warned that the directors could become personally liable for the debts of the company which continued to trade in an insolvent state. In June 1987 the director took up alternative employment with a substantial customer of the company. Prior to leaving a third car was purchased for £4,269.44 to assist with the new employment. The company ceased trading in November 1987 and went into liquidation in May 1988 with a substantial deficiency. It was held that by the end of 1986 the company could not avoid going into insolvent liquidation. The directors were accordingly liable to make a contribution to the company's assets equal to the loss caused by trading after that time. Also a liability under Section 212 (misfeasance) was found. There was no injustice in making orders under both sections so long as there was no double compensation.

Interestingly the judge wondered whether a reasonably prudent director would have allowed the company to commence to trade at all; it had no capital base and its only assets were purchased by bank borrowing or acquired by hire purchase. In the end the judge concluded that the initial decision to commence trading had been legitimate. The factors were director's previous business connections in the advertising and publicity fields and that his belief that sufficient business could be generated to enable the company to trade profitably could have

been entertained by a reasonable and prudent director who was conscious of duties to creditors.

Re Produce Marketing Consartiurn Limited 1989 BCLC 520.

A fruit importing company obtained commission of 3.5% on the gross sale price of fruit in UK. From summer 1986 the trading position deteriorated sharply, The company's annual overheads were in excess of £65,000 so it needed an annual turnover of at least £1,850,000 to break even. At its highest in discussions with their bank the directors anticipated the prospective turnover would be £1,600,000 - the last accounts show that the company's turnover was about £526,459 so that the commission turnover could not exceed £18,500.

Although the day to day accounting records of the company were in most respects satisfactory, the statutory accounts were always late. In January 1987 draft accounts for 84/85 and 85/86 were submitted. These were signed in February 1987 and showed the company to be in "a parlous state". The auditors certificate stated that the company could only continue to trade because of bank support (which was lost immediately prior to liquidation.)

All the usual features were present such as escalating overdrafts and suppliers' demands for payment. In February 1987 the company's auditors wrote warning of the possibility of directors' liabilities. The case is of particular importance because Knox J. developed the concept of constructive knowledge in the context of Section 214. It was noted that the company required to uphold certain minimum standards. A director is taken to have constructive knowledge of information which would have been available had the company complied with its obligations under the Companies Act 1985. Thus even though the accounts were not in fact produced until January 1987, the directors were deemed to have that knowledge on the date the accounts were due which was at the end of July 1986 for the financial year ending 30th September 1985.

THE PROBLEM OF RELIANCE

Norman & Anr. v Theodore Goddard & Ors (Quirk - Third Party) 1992 BCC 14

A property company formed part of the assets of a substantial trust administered by Theodore Goddard. The trust was managed by Mr. Andrew Bingham who was a senior partner of that firm. At Mr. Bingham's instigation the company engaged a director, Mr. Quirk, to manage its affairs. Mr. Quirk was an experienced property manager but at the outset explained he had "no experience of being a director of a commercial company and no knowledge of company law". To Mr. Quirk, Mr. Bingham was the picture of a respectable member of a very eminent firm of city solicitors but in fact Mr Bingham was a fraud. Mr. Quirk was subsequently advised by Mr. Bingham to place sums amounting to £400,000 in an offshore company called Gibbon "to obtain tax exemption on interest earned. "Not altogether seriously" Quirk queried whether the arrangement was legal and whether the funds could be withdrawn at short notice. To both questions he received reassuring answers from Mr. Bingham.

The Court decided in the particular circumstances some detailed questions by Mr. Quirk would only arise if there was some ground for not accepting Mr. Bingham's veracity or expertise in tax avoidance and the management of offshore funds. A director who undertakes the management of the company's properties is expected to have reasonable skill in property management but not in offshore tax avoidance. The director performing duties on behalf of a company need not exhibit a greater degree of skill than may reasonably be expected from a person undertaking those duties. Accordingly Mr Quirk was found to have acted reasonably in accepting the assurances without making an independent enquiry.

Similar problems arose in DKG supra but the advice to the company of an in-house quantity surveyor that funds would be forthcoming was disregarded by the court because the surveyor was not in possession of all the facts and in particular was not shown the black book.

And again in Dyer v_ Hislop (see below).

THE PROBLEMS OF OPTIMISM

Dyer v. Hislop (Sheriff Stewart 10 August 1994)

A speculative building company was formed in December 1988. It was core of a group of companies designed as Bruce Court (something;) Limited. The first year's accounts were not signed until February 1991. They were certified on a "going; concern" basis and without any post balance sheet event. Although the company employed a full-time bookkeeper, the computerised accounts did not fulfil the requirements of Section 221 Companies Act. 1985; the details of property realizations were kept by the company's solicitors. Management accounts were not maintained although the company made cash flow projections of proposed projects. The company was warned by their auditors about trading whilst insolvent and no statutory meetings were held. The building recession hit Dundee at the start of 1990. Throughout its life the company made losses on most if not all developments leaving unsecured creditors short of in excess of £150,000. It was held that no later than 31st October 1990, when the accounts required to be lodged, the directors ought to have concluded there was no reasonable prospect that the company would avoid going into insolvent liquidation.

An interesting feature of the case was that the successful outcome of three of the developments in which the company was involved could have dwarfed the trading losses. Two depended upon "a gentleman's agreement" with a local property magnate and one upon an agreement with another "Bruce Court company" and the grant of planning consent. The Court held it was not reasonable for a speculative building company to take the substantial potential gains from any of these developments into account because none were properly or sufficiently constituted.

Re Hawkes Hill Publishing Co Ltd (2007 EWCA Civ 1201)

Although the directors did not have the benefit of professionally prepared accounts until 16 month after commencing to trade they ought to have known that the company was struggling because the initial working capital was exhausted and the Company was balance sheet insolvent.

Lewison J concluded that it was not established by Liquidator that the directors had no reasonable grounds for believing that it would not survive. (*Note the onus*). New businesses often struggle to make a profit in the early years and the forward booking for advertising space for the magazines was encouraging.

THE PROBLEM OF KNOWLEDGE

Re Barings Plc (No 5)

Ronald Baker was a senior director of the operating subsidiary that employed Nic Leason. He became aware that L controlled both back and front office from an internal audit report but failed to require these functions to be separated. It took six months to impose some limits on L's authorisation but Baker took no adequate steps to enforce them. He failed to pay attention to other warning signals and failed to take steps to fully understand the business L was carrying on.

“ Directors have both collectively and individually a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.

Whilst directors are entitled.....to delegate particular functions to those below them in the management chain and to trust their competence and integrity to a reasonable extent , the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.....The extent of the duty and the question of whether it has been discharged must depend on the facts of each particular case , including the director's role in the management of the company.

Re Continental Assurance Co of London (2001 WL 720239)

Accounts prepared specifically for the crisis board meetings suggested that C had assets of about £4.5m .Whilst this figure reflected a serious erosion of capital the directors concluded C was solvent and could continue to trade while efforts were made to find a buyer. The liquidators claimed that aggregate adjustments of over £5m should have been made to reflect claims “ incurred but not reported”.

At every board meeting during the crisis period assurances had been sought from the finance director and the auditors that C was solvent. When further losses were reported the directors decided that C should take on no more new business and consulted insolvency practitioners.

The judge concluded that the directors were doing their honest best and the real question was whether that was sufficient. Directors in their position were expected to have a basic grasp of the accounting principles applicable to insurance companies and to be able to read and understand the company's accounts , to participate in discussions 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. They were active in keeping the company's financial position under close and continuous review and a reasonably diligent person could not have been expected to do any more.

“ I cannot refrain from remarking that , if 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.” Park J

A CONTRIBUTION - BUT HOW MUCH ?

Section 214(1) ... to make such contributions (if any) to the company's assets as the court thinks proper.

Re DKC Contractors Limited 2990 BCC 903

A contribution equal to the amount of trade debts after 1st May.

Re Purpoint Limited '1991 BCC 121

Directors liable to make a contribution equal to the loss caused by the continuation of trading after the date the company could not avoid insolvent liquidation.

Re Produce Marketing Consortium Limited 1989 BCLC 520

"The court's discretion was primarily compensatory rather than penal and prima facie the amount that a director should be ordered to contribute under 5.214(1) should be the amount by which the company's assets had been depleted by the director's conduct. In fixing the amount that the director should be obliged to contribute under the section the court was given a very broad discretion and the fact that there was no fraudulent intent should not in itself be a ground for restricting the contribution to a nominal or low figure although it would not be right to ignore this fact totally."

--- But J. Knox based his award on the increase in deficit between the time the company ought to have ceased to trade and the ultimate deficit. In doing so he based his figures on the lower figures the Company's accounts demonstrated rather than the overall deficit as found by the liquidator.

Re Continental Assurance of London Plc (supra)

Park J:

“ 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 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 consider trading) is recoverable.

Where ...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 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”.

WHEN LIABILITY ARISES

Re DKG Contractors Limited 1990 BCC 903

In April the warning signs were such as the directors should have initiated financial control.

Re Produce Marketing Consortium 1989 BCLC 520

The directors were deemed to have knowledge of the contents of the statutory accounts from the time they required to be lodged even though the accounts were not actually available until later.

RELIEF IN TERMS OF SECTION 214 OF COMPANIES ACT' 1985?

In various cases relief has been sought in actions based on Section 214 upon the basis the director had acted "honestly and reasonably and in the circumstances ought fairly to be excused."

It has been held repeatedly e.g. see *Hall v. David* (Times, 18th February 1994) that such relief was not available in applications involving Section 214.

THE PROBLEM OF SHADOW DIRECTORS

Section 214(7) includes shadow directors under the general provisions of Section 214.

Section 215 Insolvency Act 1986. " . . . , shadow director . . . means a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity).

Re A Company No. 005009 of 1987 Ex Parte Copp & Anr 1989 BCLC 13

A company's bankers commissioned a report and exerted pressure for security of the overdraft. The bank was granted a debenture by the company requiring that all monies should be paid into their account with the bank and other onerous terms. It was held that the allegation the bank was a shadow director of the company was not obviously unsustainable.

Re Hydrodan (Corby) Limited 1994 RUC 161

The liability for wrongful trading imposed by Section 214 of Insolvency Act extended to de facto directors, de jure directors and shadow directors. The directors of a parent company which was alleged to be a shadow director of a subsidiary would not necessarily be shadow

directors of the subsidiary. But if directors of the parent company as a collective body gave directions to the directors of the subsidiary company and the directors were accustomed to act in accordance with such directions, the result would be to constitute the parent, but not its directors, a shadow director of the company.

BUT WHAT ARE SHADOW DIRECTORS' DUTIES IN RELATION to section 214?

Gore-Browne: "It can hardly be said that any particular standard of general knowledge, skill and expertise may reasonably be expected from shadow directors whose only common characteristic is the ability to force the hands of directors." (Gore-Browne on Companies 35.4).

But is that right? Not only do banks have the expertise to provide directors of high calibre , steps required of a company by shadow directors have consequences to the company and third parties.

COMMON FEATURES OF THE DECIDED CASES ON WRONGFUL TRADING

Some common threads that can draw:

1). Liability has been found in cases characterised by poor "house-keeping" - not only in the context of accounting records but also with related matters:

- (i) absences of monthly or quarterly management accounts;
- (ii) failure to submit annual accounts timeously;
- (iii) incomplete statutory records;
- (iv) no evidence of board meetings (no minutes, etc-);
- (v) failure to record important arrangements with third parties in writing and/or discussions in relation to potential new arrangements.

2. The courts appear to show a willingness to impute knowledge of the company's financial position to a director. Thus

Statutory deadlines for accounts are taken to be dates when the directors possessed the knowledge of what

the accounts contained or ought to have contained.

ADVICE ON WRONGFUL TRADING

- 1) Advice usually sought in fraught circumstances .**
- 2) Bring in Company's accountants if possible.**
- 3) Take all possible steps to fulfill Company's Act requirements on accounting records and annual returns**
- 4) Pay close attention to written records . – Board Meetings , ongoing discussions with Bank .**
 - keep working papers**
 - state why board meetings have been adjourned**
 - state who attends and for how long meetings continue**
- 5) Record all positive factors giving rise to decisions to continue to trade**
- 6) Make a record of discussions relating to potential new profitable contracts or prospects of sales of assets**

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