EdwinCoe LLP

Newsletter – Autumn 2018

Directors' duties and the twilight zone of potential insolvency

In this Newsletter, following recent cases, we examine the state of the law about the circumstances in which directors – as their companies get into financial trouble – must act in the interests of creditors, rather than shareholders, and the way in which courts will judge whether they have failed to act lawfully.

Directors will very likely know that by statute (s.172(1) of the Companies Act 2006) they are under a duty, which they owe to the company, to *"act in the way which they consider in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole",* which is to say, for the benefit of its shareholders.

They should also know that *"in certain circumstances"* this duty is modified or displaced, and they must instead *"consider or act in the interests of creditors of the company"*: s.172(3). A breach of that duty can lead to subsequent claims for financial compensation - usually by the company acting by its liquidator; it is therefore a duty which needs to taken seriously.

This Note concerns the following important and sometimes difficult questions, considered in a number of recent cases:

- **the *point* at which (or the circumstances in which) directors must act in the interests of the company's creditors, rather than its members**; and
- **the *way* in which the courts have assessed whether or not there has been a breach of duty** - in particular, whether or not a director's consideration of the creditors' interests is to be judged *"objectively"*, in effect, according to a standard of conduct set by the court or *"subjectively"*, according to what the director himself considered *"would be most likely to promote the success of the company",* even if he acted unwisely – or both.

As to the first of those issues, at common law – in other words, before the 2006 Act – where a company was insolvent, or even *"doubtfully solvent"* or on the *"verge of insolvency"*, the creditors' interests would intrude, and directors would come under a fiduciary duty (owed to the company itself) to consider the interests of the creditors, and possibly even to treat them as paramount. The underlying reason for that principle is perhaps obvious: in those circumstances, there is a risk that creditors will be left unpaid, and so, *"in a practical sense it is their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration".*

Essentially, it is that common law principle which is preserved by s.172(3) of the 2006 Act. So far so good. But the more difficult question is to assess the precise point at which the company, whilst not yet actually insolvent, is *sufficiently close* to being or becoming insolvent that the courts will consider the directors' duty to be modified in this way. In that respect, a number of recent cases provide at least some assistance.

First, in *Re HLC Environmental Projects Ltd* [2013] EWHC 2876, Mr John Randall QC considered the authorities and concluded that although there were *"varying verbal formulations"* of the test, there was no difference in the underlying principle, which was 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 or its shareholders"*, emphasis added.

However, this formulation seemed to draw forward the threshold point to a significant extent – as Rose J. colourfully put it in *BTI 2014 LLC v Sequana SA* [2016] EWHC 168, *"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 more than a remote risk of my house burning down."*

Accordingly, whilst agreeing with Mr Randall QC that the authorities do seem to treat the various different formulations of the test as being the same, Rose J. did **not** accept that *"whenever a company is "at risk" of becoming insolvent at some indefinite point in the future, then the creditors' interests duty arises unless that risk can be described as "remote""*. Furthermore, she noted that in each of the relevant cases, the financial position of the company in question was **on the facts** perfectly capable of being *"accurately described in much more pessimistic terms, as actually insolvent or "on the verge of insolvency", "precarious", "in a parlous financial state" etc"*. She therefore rejected the claim against the directors, saying that, *"It cannot be right that whenever a company has on its balance sheet a provision in respect of a long term liability which might turn out to be larger than the provision made, the creditors' interest duty applies for the whole period during which there is a risk that there will be insufficient assets to meet that liability."*

Subsequently, the issue arose in *Dickinson v NAL Realisations (Staffordshire) Ltd and others* [2017] EWHC 28, where it was considered by HHJ David Cooke. The case concerned transactions entered into at a time when the company faced the prospect of litigation which, if successfully brought against it, would have endangered its financial health, and very likely rendered any judgment unenforceable. Whilst it is apparent from his judgment that on the particular facts, the Judge hesitated before reaching his conclusion, nonetheless, he dismissed the claim, and his statement of the relevant principles is clear: *"...****the authorities do not justify a finding that the general duties of directors require them to give priority to the interests of creditors simply because there is a recognised risk of adverse events that would lead to insolvency.*** *In one sense of course the directors must always have regard to the company's liabilities – they must be satisfied in the course of its business if the business is to continue and prosper. But in ordinary circumstances this does not entail any divergence between the interests of members and creditors. It is only when some potential difference emerges that there may be a problem. This might be so if, say, the directors have to decide whether the company embarks on some long term project or investment that may benefit members in the long term, but carries risks to cash flow in the short term. If the directors must prioritise the interests of creditors, they might not be able to proceed because they must prefer short term cash flow to long term potential benefit.* ***I would be reluctant to hold that such a situation arises where the company faces a disputed claim which, if the directors' assessment of the litigation prospects turns out to be wrong, will or may bring the company down.****"* (Emphasis added.)

Finally, and most recently, in *Ball (Liquidator of PV Solar Solutions Ltd) v Hughes* [2018] BCC 196, a case which concerned an elaborate tax avoidance scheme which culminated in the payment of credits by the company to its directors, Mrs Registrar Barber identified as being *"key"*, the underlying principle stated by Mr Randall QC in Re HLC (above) – that the "*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 or its shareholders"* – albeit that the point at which the risk becomes *"real" "must be judged on a case-by-case basis"*.

Where does this leave the law? At what point does the duty to consider the interests of creditors arise?

We consider that despite the recent judgment in *Ball (Liquidator of PV Solar Solutions Ltd) v Hughes*, it is probably not right to frame the test in terms of a *"real rather than remote"* risk of insolvency, we think that would be to bring the relevant point forward to an unprecedented and unhelpful extent.

Furthermore, whilst the test is always going to be capable of formulation in different ways, by reference to different expressions more or less apposite in different cases, and whilst, as ever, disputes are to be judged on a *"case-by-case basis"*, we think the preferable expressions would convey a sense of impending insolvency – a company *"on the verge"* of insolvency, or of *"dubious"* solvency, or in a *"parlous state"*.

In any event, directors would be very well advised, if they think such a risk has or may have arisen, to consider very carefully, with their advisors, their conduct of the company's affairs.

The second issue, less problematic, in principle at least, concerns the means of assessment of a director's conduct – whether it is to be assessed subjectively or objectively.

The starting point is that the duty is fiduciary and therefore subjective in nature – the director must act in what **he** considers, in good faith, will be of benefit, whether to members of creditors. It is now commonly accepted that this is so **except** that where there is no evidence of any actual consideration of relevant interests at all, or a *"very material interest"* is overlooked (for example, the interests of a significant creditor) in which case an objective test will be applied, and the court will assess the director's conduct by reference to what an *"intelligent and honest man in the position of the director"* could reasonably have believed would have been for the company's benefit: *Re HLC*, above.

As illustrated by a recent case, *Wessely & Hughes-Holland v White* [2018] EWHC 1499, this principle can be determinative. In that case, compensation was sought against a company's director in respect of his alleged breaches of duty in executing two deeds of release in relation to various building contracts. The director's evidence – which was accepted – was that in bringing about these transactions, he had *actually* considered the interests of the company's creditors. The court therefore applied a subjective test, and found that although the director (who had *"no prior experience of running an insolvent company, where events were moving at a rapid pace and changing from day to day"*) had been "naïve", he was *not* in breach of duty because he himself had truly, subjectively, concluded that the transactions would benefit the company and its creditors. In other words, to his mind, all considerations pointed in the same direction.

Again, this aspect of the rule underlines the fact that directors must actually consider the interests of the relevant body – whether members/creditors – but protects them from liability where they have acted in good faith, albeit not necessarily in a way which the court itself would have considered more appropriate. In other words, where they have considered the correct set of interests, directors are entitled to act according to their own subjective view of what is best for the company and/or in the best interests of its creditors.

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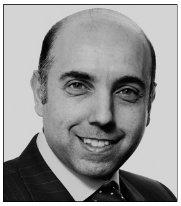

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