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Wrongful trading: two recent cases

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Continental Assurance Co of London Plc, Re (Unreported, April 27, 2001) (Ch D)

Insolv. L. 211 The purpose of this short note is to alert readers to two recent cases concerning directors' liability for wrongful trading. By way of reminder, the court's discretion to order a person to contribute personally to the assets of the company is only triggered if the company's liquidator can establish that:

(a) the company has gone into insolvent liquidation (meaning that its assets are insufficient for the payment of its debts, other liabilities and the expenses of winding-up); and

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

(c) the defendant was either a director or shadow director of the company at that time.[1]

If these elements are established the court may make an order, but is not bound to do so. A defence is available if the defendant establishes that having reached the state of knowledge referred to in (b), he or she took every step with a view to minimising the potential loss to the company's creditors that he or she ought to have taken. In practice, the key substantive element is (b) as the matters in (a) and (c) will usually be self-evident.

Re Continental Assurance Co. of London plc

The decision in *Re Continental Assurance Co. of London plc* [2] is perhaps the most significant pronouncement on section 214 to date. The trial lasted 72 days and required the court to grapple with a welter of complex issues, both factual and legal. Park J.'s mammoth judgment is accordingly not for the faint-hearted. However, it contains a detailed and careful analysis of several aspects of section 214 and provides a useful illustration of the substantive difficulties that face officeholders who might be contemplating proceedings.

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

In *Continental Assurance* the only point in issue on liability was whether in mid-1991, the directors knew or ought to have concluded that there was no reasonable prospect that Continental would avoid insolvent liquidation. The liquidators' primary case was (i) that as a result of the travel insurance losses Continental was “balance sheet” insolvent in July 1991 and had no prospects of survival, and (ii) that the directors knew or ought to have realised this and would have so realised had they applied appropriate accounting policies. Accounts prepared specifically for consideration by the board at crisis meetings during July 1991 suggested that Continental had net assets of about £4.5 million. This figure reflected a serious erosion of its capital but led the directors to conclude that the company was solvent and could continue to trade while efforts were made to find a buyer. ***Insolv. L. 212*** Relying on expert evidence, the liquidators contended that aggregate adjustments of over £5 million should have been made to the accounts that, if made, would have shown Continental to be insolvent in July 1991. It was alleged, for example, that the accounts made inadequate provision for claims "incurred but not reported", *i.e.* claims arising from events that had occurred within an accounting period but had not been notified to Continental as at the accounting date. The liquidators' secondary case was (i) that, even if Continental was solvent in July 1991, it did not comply with the Department of Trade and Industry (DTI) margin of solvency applicable to insurance companies and, as such, had no prospects of survival, and (ii) that the directors knew or ought to have realised this.

Weighing both sides' expert evidence, Park J. found, on the balance of probabilities, that the company was still technically solvent in July 1991 but was in breach of the DTI's margin requirement. However, he held that the defendants were not liable and stressed that he would have reached the same conclusion on liability had he found that the company was factually insolvent in July 1991. On the basis of the information available to them at the time, the defendants had acted reasonably in deciding that Continental could continue trading with a view to finding a buyer for the business. When the losses were first reported, the board had specifically raised the question of whether the company could properly continue to trade. The finance director and the auditors had been instructed to conduct a detailed appraisal of Continental's financial position. At every board meeting during the crisis period, assurances had been sought from the finance director and from the auditors that Continental was still solvent. When further losses were reported leading the directors to conclude in December 1991 that Continental had become insolvent, they gave instructions that it should not carry out any more new business and took advice from insolvency practitioners. In the words of the judge, "the directors … took a wholly responsible and conscientious attitude, both to Continental's position and to their own responsibilities as directors".

Park J.'s conclusions on liability can be justified by reference to section 214(4). The effect of section 214(4) is that a director can only be liable if the court finds that a reasonably diligent person having both (i) 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 (ii) the general knowledge, skill and experience that that director has, would have decided to cease trading. This test sets an objective minimum standard which obliges all directors to acquire and maintain a basic knowledge of the company's financial position.[3] In the judge's view, the standard to be applied to Continental's directors was that of the "intelligent layman". Directors in their position would be expected to have a basic grasp of the accounting principles applicable to insurance companies, such as claims incurred but not reported. They would also be expected to be able to read and understand the company's accounts, to participate in discussion of the accounts, and to ask intelligent questions of the finance director and auditors. However, it was setting the standard too high to expect them to have the specialist knowledge of an expert in the field of insurance company accounting. The evidence showed that Continental's directors were active in keeping the company's financial position under close and continuous review. A reasonably diligent person in their position could not have been expected to do any more. On the same basis, it was reasonable for the directors to conclude from the material available to them that Continental was still operating within the DTI's margin of solvency in July 1991 even though, in hindsight, it was established that this was probably not the case.[4]

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

(a) The section states that the director "is to be liable to make such contribution (if any) to the assets of the company as the court thinks proper". As such the court clearly has a discretion whether or not to order a contribution. However, that discretion is not entirely at large.

(b) The basic measure is the increase in the net deficiency that arises as a result of the liquidation being delayed.[5]

(c) However, any contribution ordered will not necessarily equate to the increase in net deficiency. In fixing the size of the contribution, the court ***Insolv. L. 213*** must consider whether there is a sufficient connection between the increase in net deficiency and the factors which made the decision to continue trading wrongful. Thus, before the court will be prepared to order contribution, it is not enough for the liquidator to say, on a "but for" basis, that if the company had ceased trading, a particular loss would not have been suffered. There is an onus on the liquidator to explain each element of the increased deficiency and to connect it to the unlawful conduct of the directors. Not every loss sustained after the directors reach a wrongful decision to continue trading (or wrongfully fail to consider the question of whether or not the company should continue trading) is recoverable.[6]

(d) Where applications under section 214 are made against two or more directors the starting point is that their liability is several. This does not preclude the court from imposing joint and several liability in the exercise of its discretion. However, the focus of the section is on the individual director rather than on the collective conduct of the board of directors. For this reason, joint liability should only arise where the court positively exercises its discretion to impose it.

On the evidence, Park J. held that the liquidators had failed to establish any increase in net deficiency between July 1991 and March 1992. Thus, he would have made no order against the defendants even had the liquidators succeeded on the liability issue.

Official Receiver v. Doshi

The *Doshi* [7] case is of great interest on the practical level as, for the first time, a liquidator's wrongful trading action and an application by the Official Receiver for a disqualification order pursuant to section 6 of the Company Directors' Disqualification Act 1986 were tried together in consolidated proceedings.[8] The defendant was a director of VK Vintners Ltd ("VKV"), a company that traded between February 1992 and March 1995. VKV imported wine from Europe and distributed it to off-licences in the United Kingdom. The company had started life by taking over the assets of another company owned by members of the defendant's family shortly before that company went into compulsory liquidation with a deficit in excess of £1 million. VKV was compulsorily wound up in March 1995 at the behest of Customs and Excise on the basis of substantial VAT arrears. By this time, VKV's assets had been transferred to another company controlled by the defendant, which also traded under the name "VK Vintners". Six months before the winding-up order was made, Customs officers investigating allegations of VAT fraud had raided VKV's premises.

As in *Continental Assurance,* the central issue in the wrongful trading proceedings was whether the defendant knew or ought to have concluded that there was no reasonable prospect that VKV would avoid going into insolvent liquidation. Hart J. held that he ought to have so concluded by November 1992 at the latest and ordered him to contribute to the company's assets a sum equivalent to the proportion of VKV's deficiency attributable to creditors whose debts were incurred after that date (the precise sum to be determined after further argument). The key evidence in the case surrounded VKV's relationship with RBIF, a debt factoring company, which was VKV's principal source of working capital for most of its trading life. The judge found on the evidence that, in order to maintain its RBIF funding at a sufficient level for VKV to continue trading, the defendant submitted false ("fresh air") invoices to RBIF for wine that customers had not ordered. These invoices were financed up front thus enabling the defendant to shore up VKV's cash flow position. Subsequently, a VKV cheque would be tendered to RBIF in payment on the pretence that VKV had collected the sums invoiced direct from its customers in cash.[9] The liquidator's case, accepted by Hart J., was that the inevitability of VKV's eventual liquidation must have been apparent to the defendant from the time (November 1992) when the practice of fresh air invoicing first started. It was inferred that the company was only able to continue trading after this date because of recourse to fresh air invoicing and that the defendant was aware of this. One might add that the fact that the defendant was willing to engage in such a desperate practice was itself indicative of the ***Insolv. L. 214** company's financial plight. As well as declaring the defendant liable to contribute to VKV's assets under section 14, Hart J. disqualified him for 12 years. On this aspect of the case, the judge was satisfied that the findings made in relation to fresh air invoicing alone qualified the case for the top bracket of disqualification.[10] In any event, this misconduct was compounded by other proven incidents of unfit conduct including deliberate non-payment and evasion of VAT.

Comment

The two cases outlined could not be more contrasting. The directors in *Continental Assurance* came from a business environment far removed from the world of Mr Doshi. The former were doing their honest best and the real question was whether their honest best was good enough. The latter was prepared to engage in fraudulent practices to keep his business alive. Of the two, *Continental Assurance* is the more important in terms of the substantive law whereas *Doshi* is significant because of its procedural novelty.

Continental Assurance provides a good illustration of how difficult it can be to bring successful wrongful trading proceedings in cases where the board of directors has functioned properly and made decisions on the basis of up-to-date appraisals of the company's financial position. In cases of this type, the court is likely to take great care to ensure that its view of the defendants does not become too coloured by hindsight.[11] Liquidators may also be confronted by judicial fears that too casual a use of section 214 could result in over-deterrence. As Park J. himself said, "… I cannot refrain from remarking that, if the non-executive directors were liable to pay millions of pounds to the liquidators in this case, it is hard to imagine any well-advised person ever agreeing to accept appointment as a non-executive director of any company". To succeed, it seems clear that liquidators must be able to point to some other aspect of the defendant's conduct that might incline the court to be less painstaking. Thus, there appear to be greater prospects of success in cases where the directors failed to keep proper financial records[12] or buried their heads in the sand in the hope that the company's problems would go away.[13] *Doshi* suggests that this is true also of cases where there is evidence of fraud from which negative inferences about the company's financial position and the defendant's state of knowledge can be drawn.

In line with *Re Sherborne Associates Ltd,*[14] *Continental Assurance* requires the liquidator to identify a precise date or dates on which it is alleged that the defendant knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. This is consistent with the statutory expression, "at some time". Thus, out of fairness to the defendant, the liquidator will not be allowed to plead that the company had no reasonable prospect of avoiding insolvent liquidation "at such date as the court may determine". The liquidator must specify a date (or dates), and stand or fall by reference to the date(s) specified. It appears from the transcript that the court in *Doshi* was not quite as rigorous in observing this requirement.

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

Insolv. L. 2001, 6(Dec), 211-214

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[1] It should be noted in passing that the provision also now applies to the members of an insolvent limited liability partnership by virtue of the Limited Liability Partnerships Regulations 2001 (S.I. 2001 No. 1090).

[2] April 27, 2001, ChD, unreported.

[3] Subjective factors can be used to raise the threshold test in (i) but not lower it: see *Re Brian D. Pierson (Contractors) Ltd* [1999] B.C.C. 26.

[4] The careful and sympathetic application of s.214(4) to Continental's directors is of wider interest bearing in mind that the same test applies to determine whether a director has breached the general duty of care and skill.

[5] Presumably, the costs of the liquidation should not be included in calculating the increase in deficiency.

[6] *Re Brian D. Pierson (Contractors) Ltd* [1999] B.C.C. 26. The position in fraudulent trading cases is broadly similar although under s.213 the contribution awarded may include a punitive as well as a compensatory element: see *e.g. Morphites v. Bernasconi* [2001] 2 B.C.L.C. 1.

[7] [2001] 2 B.C.L.C. 235.

[8] Hart J. presided at the trial. The proceedings had earlier been consolidated by order of Neuberger J. There is no transcript of the earlier hearing. Mr Neil Smyth of Messrs Taylor Joynson Garrett (the liquidator's solicitors) was kind enough to speak to the writer about the case. In the light of this conversation, it appears that Neuberger J. merged the proceedings largely of his own motion on the ground that two separate trials were not merited such was the overlap between the legal and factual questions in issue.

[9] Although the factoring agreement provided that collection of the assigned debts would be the responsibility of RBIF, the debts were, in

practice collected by VKV. This arrangement was considered by RBIF to make commercial sense because many of VKV's customers were small retailers with only a limited grasp of English who were likely to be more amenable to a personal approach from the defendant or his sales force than they would be to a formal approach from a debt factor.

[10] Meaning a ban for over 10 years: see *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch. 164 at 174.

[11] Heeding the cautionary words of the judge in *Re Sherborne Associates Ltd* [1995] B.C.C. 40 warning against “the danger of assuming that what has in fact happened was always bound to happen and was apparent”.

[12] See *e.g. Re Produce Marketing Consortium Ltd (No. 2)* [1989] B.C.L.C. 520; *Re DKG Contractors Ltd* [1990] B.C.C. 903; *Re Purpoint Ltd* [1991] B.C.L.C. 49.

[13] This is because the court will readily infer that the directors ought to have known that which would have been apparent had the records been up to scratch or had the question of continuing to trade been made subject to a regular detailed review.

[14] [1995] B.C.C. 40.

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