

## Disciplining the directors of insolvent companies

I am honoured to contribute to this special issue dedicated to Professor Moss, who was a distinguished member of the Faculty of Law at Oxford. I loved teaching with Gabriel and took every opportunity to run new ideas by him. He received each request with generosity and good humour, and his responses greatly enriched my understanding. We in the Faculty mourn Gabriel's passing but are grateful for the many years in which he offered his time, energy and expertise to students and staff here.

### Introduction

In this piece I make some observations about three recent developments in the law governing the treatment of the directors of insolvent companies<sup>1</sup>: first, the decision of Mr Justice Snowden in *Grant v Ralls*<sup>2</sup> on the approach to determining quantum in 'wrongful trading' cases brought under s.214 (liquidation) or s.246ZB (administration) of the Insolvency Act 1986; secondly, the decision of the Court of Appeal in *BTI 2014 LLC v Sequana SA*<sup>3</sup> on the scope the common law duty-shifting rule (the 'rule in *West Mercia Safetywear v Dodd*'); thirdly, the new compensation order regime in the Company Directors Disqualification Act 1986, on which there is now authority (*Re Noble Vintners Ltd*<sup>4</sup>). I have tried to analyse each with Professor Moss's work in mind, recalling in particular his readiness to debate questions of policy as well as principle (the two were inevitably intertwined, for what good was precedent if the rule it engendered did not serve the underlying goal?), and his confidence in the ability of English judges to craft sensible solutions to problems left unresolved by the statute.

I conclude that *Ralls* was principled, in the sense of being in line with the authorities, but would be unattractive in policy terms were it not for the rule in *West Mercia Safetywear Ltd v Dodd*;<sup>5</sup> that the refinement of that rule in *Sequana* is attractive as a matter of principle and policy, but that the application of the rule in cases involving factual preferences (of which *Ralls* was an example) is remedially somewhat difficult; and that the introduction of the compensation order to the Company Directors Disqualification Act 1986 provides a clearer route to a remedy in a preference case, but is unattractive in policy terms because it goes far beyond such cases without an obvious reason for doing so, such that we may well have been better off without the reform.

#### I. The decision in *Grant v Ralls*

*Grant v Ralls* concerned a construction company that went into administration (and then liquidation) after a period of losses caused by a combination of the 2008 recession and adverse weather conditions. Snowden J decided that the company's directors ought to have concluded by 31 August 2010 that there was no reasonable prospect of avoiding insolvent liquidation. The directors had honestly believed both before and after that time that the company's prospects could be turned around by completing a deal with a third party investor, but should have concluded by the end of August that this investor could no longer be relied upon, and that

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<sup>1</sup> In doing so I draw on some of my previous work, including van Zwieten, 'Director liability in insolvency and its vicinity' (2018) 38(2) Oxford Journal of Legal Studies 382.

<sup>2</sup> [2016] EWHC 243 (Ch); [2016] Bus. L.R. 555.

<sup>3</sup> [2019] EWCA Civ 112; [2019] 2 All E.R. 784.

<sup>4</sup> [2019] EWHC 2806 (Ch).

<sup>5</sup> (1988) 4 B.C.C. 30.

there was then no reasonable prospect of avoiding insolvent liquidation.<sup>6</sup> The judge also held that between then and the day on which the company entered administration (31 October 2010) the directors had not taken “every step with a view to minimising the potential loss to the company’s creditors” that they ought to have taken<sup>7</sup>, such that the court had power to declare them liable to make such contribution to the company’s assets as it thought proper.<sup>8</sup> But he held that it would not be appropriate to order such a contribution, for the reason that he was not satisfied on the balance of probabilities that the continuation of trading had caused any, or any material, increase in the net deficiency.<sup>9</sup> Indeed, the judge thought that it was likely that there had been an *improvement* in the net position of the company over the relevant time, not only because the company had cut costs while completing projects, improving its net profits, but also because by completing such projects the company had been able to realise book debts that would not likely have been able to be realised at full value in insolvency proceedings.<sup>10</sup>

The reason why Snowden J thought that the directors had not made out the defence under s.214 (that they had taken every step with a view to minimising the potential loss to the company’s creditors as they ought to have taken) was because of the differential effect that trading after 31 August 2010 had on the company’s creditors. As at 31 August, the company owed £554,530.83 to its bank under an overdraft facility. The debt was secured, but if the company had immediately entered liquidation, the prescribed part at least would have been deducted for unsecured creditors.<sup>11</sup> By the time the company entered insolvency proceedings, the overdraft had been repaid, meaning that no such deduction would be made. Some other pre-31 August creditors had not been paid, and some new creditors (largely trade creditors) had been acquired and not yet paid. The directors argued that if their actions were “aimed at reducing the net deficit of the company” they had made out the defence.<sup>12</sup> Snowden J rejected this, reasoning:

“Given the express wording of section 214(3) (“every step”), I think that it is plain that section 214(3) is intended to be a high hurdle for directors to surmount. I therefore think that it is right to construe section 214(3) strictly and to require a director who wishes to take advantage of the defence offered by that subsection to demonstrate not only that continued trading was intended to reduce the net deficiency of the company, but *also that it was designed appropriately so as to minimise the risk of loss to individual creditors*. Otherwise a director could make out the defence under section 214(3) by claiming that he traded on with a view to reducing the overall deficiency for creditors as a general body, irrespective of how he achieved that result as between creditors.”<sup>13</sup>

As the directors had not demonstrated that the trading had been so designed, they were in principle liable to be ordered to make a contribution to the company’s assets. But the authorities also suggested that:

“the correct approach to determining whether the directors should be required to make a contribution... is... to ascertain whether the company suffered loss which was caused by the continuation of trading by the company after 31

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<sup>6</sup> (nx) at [216]. As to the period leading up to this, see [191]-[209], the judge placing weight on the views of the insolvency practitioner who had been advising the directors at this time.

<sup>7</sup> As required to make out the defence in s.214(3).

<sup>8</sup> Section 214(1).

<sup>9</sup> (nx) at [268].

<sup>10</sup> (nx) at [269]-[273], [260]-[261].

<sup>11</sup> See s.176A of the Insolvency Act 1986.

<sup>12</sup> (nx) [243], see also [224], [221], though the latter passages seem directed more to results than aims.

<sup>13</sup> (nx) [245].

August 2010 until the company went into administration... and that as a starting point this should be approached by asking whether there was an increase or reduction in the net deficiency of the company as regards unsecured creditors as between the two dates”.<sup>14</sup>

As there had been no increase in the net deficiency, there was no loss to the company to be compensated by the making of a contribution order.

It is of course not a prerequisite to liability under s.214 that directors have continued trading after the point in time when they knew or ought to have known that insolvent liquidation could not be avoided.<sup>15</sup> But Snowden J was surely right to conclude that on the current state of the law a contribution can only be ordered to compensate for loss caused to the company by whatever the directors did (or did not do) after the point in time when they knew or ought to have known that insolvent liquidation could not be avoided,<sup>16</sup> such that if there has been no increase in the net deficiency over the relevant period there is no loss to compensate for.<sup>17</sup> The authorities are first instance authorities, but there are many, and as Professor Moss pointed out in a characteristically clear survey, they appear with one exception to go in the same direction.<sup>18</sup> To decide that a compensation order could be made to reflect the fact that a director’s actions (or inactions) caused loss to one or more creditors even if they caused no loss to the company would have been a significant change to settled law. Such a change would, in my view, be difficult to justify in light of the fact that s.214 orders a contribution be made to “the company’s assets”<sup>19</sup> rather than those of any creditors, a feature that provides support for an interpretation of the provision that focuses on corporate rather than creditor loss.<sup>20</sup>

The decision in *Ralls* on quantum under s.214 seems to me, then, to be a principled one. But is it desirable in policy terms to have a wrongful trading rule that does not provide a remedy where the position of some creditors is improved relative to others in the period leading up to the commencement of insolvent liquidation? The mere fact that some creditors have been paid and others have not been, or that some creditors have been paid and some new creditors acquired, over the relevant period<sup>21</sup> does not seem to me to provide sufficient basis for imposing personal liability on directors. If it were, then it would generally not be possible to trade at all after directors know or ought to know that there is no reasonable prospect of avoiding insolvent liquidation, for trading will inevitably require the payment of some liabilities and the incurring of others. It is important to permit directors to trade on after the relevant time, for in some circumstances this will maximise the value of the estate (as in *Ralls*, as it happens). The flexibility of the rule (and the related capacity for value maximisation)

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<sup>14</sup> (nx) [241], drawing on *Re Continental Assurance Co of London plc* [2007] 2 B.C.L.C. 287, and *Re Purpoint Ltd* [1991] B.C.L.C. 491.

<sup>15</sup> Gabriel Moss QC, ‘No compensation for wrongful trading – where did it all go wrong?’ (2017) 30(4) *Insolv. Int.* 49.

<sup>16</sup> Loss which would have been suffered anyway is thereby excluded: (nx) [242].

<sup>17</sup> See van Zwieten (ed) *Goode on Principles of Corporate Insolvency Law* (5<sup>th</sup> ed, 2018, Sweet and Maxwell), [14-54]-[14-55].

<sup>18</sup> Moss (nx), identifying *Re DKG Contractors Ltd* [1990] B.C.C. 903 as an outlier.

<sup>19</sup> Section 214(1).

<sup>20</sup> See also (nx) at [235]-[236], Snowden J making a similar point about the destination of recoveries.

<sup>21</sup> i.e. that between when the directors knew or ought to have concluded that there is no reasonable prospect of avoiding insolvent liquidation and the commencement of insolvency proceedings.

would be lost if s.214 were replaced with a mandatory filing rule that simply required directors to commence proceedings at the relevant time.<sup>22</sup>

There are, however, some cases in which it seems entirely appropriate to make directors personally liable in relation to the payment of some creditors ahead of others. One is where directors cause the company to incur new debt for the purpose of paying off old debt in circumstances where they know the new debt will not be able to be repaid when it falls due ('robbing Peter to pay Paul'<sup>23</sup>). Such conduct will, however, be dishonest for the purposes of the fraudulent trading rule in s.213, so there should be a route to a remedy in these cases.<sup>24</sup> Another case in which personal liability appears appropriate is where directors utilise existing company assets to pay some creditors ahead of others with a view to extracting some indirect benefit for themselves. Like the first category of case, the conduct of a 'mini-liquidation' for personal gain is a species of fraud on creditors, and it would be most unfortunate if unpaid creditors had no recourse to the directors in such a case. If *Ralls* and the authorities it drew upon remain good law, then s.214 will provide no remedy, for the payment of a preference causes the company no loss. There is, however, another route to a remedy: as I explain below, the rule in *West Mercia Safety v Dodd* has been applied to require directors of insolvent companies who authorise payments to creditors self-interestedly, in breach of their fiduciary duties, to restore to the company that which has been paid out to creditors.<sup>25</sup>

Before considering the rule in *West Mercia* as refined by *Sequana*, it is worth noting that *Ralls* falls into neither of these categories of case. *Ralls* was not a case in which old creditors were paid using new borrowings: rather, the bank and other pre-commencement creditors were paid from realising assets (the contracts), albeit with the support of some new trade creditors, and because these contracts were completed at cheaper cost than initially forecast,<sup>26</sup> there was more to distribute than there would have been if the company had immediately entered into liquidation. *Ralls* seems closer to the second category of case, for it involved realising largely existing assets to pay some pre-commencement creditors, including the secured bank, ahead of others. But the payments appear to have been made for commercial reasons, rather than self-interestedly.

At its highest, then, *Ralls* is a case in which some creditors were paid ahead of others in circumstances where the directors could not reasonably have expected the unpaid creditors to recover in full. I am not sure that it is desirable to impose personal liability on directors in such a case. The benefits of providing compensation to unpaid creditors must be weighed against the costs of signalling to directors that they are required to evaluate the differential impact of continued trading on creditors even where (i) continued trading is reasonably expected to maximise the value of the estate, and (ii) any payments made to creditors are not motivated by a desire to improve the position of the payee. Once insolvent liquidation is inevitable, it seems

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<sup>22</sup> Horst Eidenmueller, 'Trading in times of crisis: formal insolvency proceedings, workouts and incentives for shareholders/managers' (2006) 7 *E.B.O.R.* 239, 250; Paul Davies, 'Directors' creditor-regarding duties in respect of trading decisions taken in the vicinity of insolvency' (2006) 7 *E.B.O.R.* 301, 314.

<sup>23</sup> I am not convinced that Peter is "robbed" if the director honestly (even if unreasonably) believes that Peter will be repaid. That is a more difficult case, as I say below, at text to nx.

<sup>24</sup> See Goode (nx) at [14-25], discussing *R. v Grantham* [1984] 2 All E.R. 166 and noting the difference with wrongful trading at fn.162; see also at [14-44].

<sup>25</sup> See below, text to nx. This builds on van Zwieten, 'Director liability in insolvency and its vicinity' (2018) 38(2) *Oxford Journal of Legal Studies* 382.

<sup>26</sup> And because the action for the price could be brought outside of the context of insolvency proceedings: above, text to nx.

plain that a director who “acts to advance the interests of a particular creditor, without believing the action to be in the interests of creditors as a class”<sup>27</sup> should be exposed to personal liability (as they are, by virtue of the rule in *West Mercia*<sup>28</sup>). Less clear is whether a director should be required to refrain from taking action that benefits creditors as a class even if some creditors are privileged over others as a consequence. This requires value preservation to be sacrificed in service of *pro rata* distribution, and I am not sure this is necessarily desirable. It follows from this that I have some concerns about requiring directors to demonstrate that continued trading was “designed appropriately so as to minimise the risk of loss to individual creditors” before they can escape a finding that they engaged in ‘wrongful trading’, as *Ralls* appears to require.

## II. *Sequana* and the duty-shifting rule

The *Sequana* case concerned the payment of two dividends by a wholly owned subsidiary to its parent company. The dividends were paid by way of set-off of an inter-company debt owed by the parent to the subsidiary. At the time that the dividends were authorised the subsidiary had ceased to trade and its only liability was a contingent one it had in relation to environmental pollution caused by a business it had historically acquired (and since disposed of). The company had taken out insurance in relation to the contingent liability, and had the additional benefit of some historic insurance policies, and the directors took the view that even after making provision for the difference between the value of these policies and their best estimate of the liability, there was a surplus that could be distributed to the parent to reduce (by way of set-off) the amount owed by the parent to it.<sup>29</sup> A dividend was declared. The following year, the view was reached that the insurance policy was sufficient to cover the contingent liability, such that there was an additional amount (that which had previously been set aside as provision) that could be distributed to the parent, again to reduce (by way of set-off) the amount owed by the parent to the subsidiary.<sup>30</sup> A second dividend was declared and paid. The effect of reducing the debt owed by the parent company was that (to the extent of the reduction) the claim of the subsidiary to payment by the parent could no longer be applied in satisfaction of the subsidiary’s clean-up obligations in the event that the insurance policies proved insufficient.<sup>31</sup>

The subsidiary’s obligation in relation to the clean-up costs was shared with two other companies, and one of these companies challenged the dividends, both directly (in its capacity as a creditor of the subsidiary, on the basis that the subsidiary was obliged to indemnify it in relation to the clean-up costs) and on the basis of an assignment procured from the company. As assignee, the company contended that the dividends could not have been paid under Pt 23 of the Companies Act 2006, alleging *inter alia* that the solvency statement required by s.643 could not have been properly given<sup>32</sup>, and that if they could have been paid, they should not have been because of the rule in *West Mercia Safetywear v Dodd*. As creditor, the company contended that the dividend transactions were liable to be unwound as transactions in fraud of creditors under s.423 of the Insolvency Act 1986. The claim that the dividends could not have been paid under Pt 23 of the Companies Act 2006 failed at first instance and there was no appeal from this. In the Court of Appeal, attention focused on the *West Mercia* and s.423

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<sup>27</sup> *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch), [2012] 2 B.C.L.C. 369, at [268].

<sup>28</sup> See below, text to nx.

<sup>29</sup> (n3) [15]-[16].

<sup>30</sup> *ibid* [17]-[18].

<sup>31</sup> *ibid* [20].

<sup>32</sup> *BTI 2014 LLC v Sequana SA* [2016] EWHC 1686 (Ch), [2017] Bus. L.R. 82, [312] *et seq.*

claims. I focus here on the *West Mercia* claim, which failed at first instance and on appeal, but note for completeness that the s.423 claim succeeded.

It was contended that in authorising the dividends the directors of the subsidiary had acted in breach of the duties they owed the subsidiary, as those duties were affected by the rule in *West Mercia Safetywear v Dodd*. The effect of that rule is that the directors of an insolvent company are required to have enhanced regard to the interests of creditors. As I have explained elsewhere,<sup>33</sup> the rule does not work by imposing on directors a new duty owed directly to creditors. Nor does it work by imposing a new duty owed to the company. Rather, the content of the duties that directors *already* owe to the company is altered so as to require enhanced regard for creditors, viewed as a class or as a whole.<sup>34</sup> Thus, for example, what may be a proper purpose for a director of a solvent company may be an improper purpose for a director of an insolvent company, once the interests of creditors as a whole are given due regard.<sup>35</sup> Such breaches cannot be authorised or ratified by shareholders.<sup>36</sup> This is an essential restriction; without it the protection offered by the rule to creditors would be rendered nugatory.

These aspects of the *West Mercia* rule are I think relatively settled, but two other aspects of the rule have been less clear.<sup>37</sup> *First*, although it is clear that the rule applies when the company is actually insolvent in a balance-sheet test, it has not been clear how much earlier than this it is capable of applying. In *Bilta v Nazir*<sup>38</sup> members of the Supreme Court described the rule in obiter as applying when a company was “insolvent or bordering on insolvency”;<sup>39</sup> at first instance a range of formulations have been used, including “where a company is insolvent or of doubtful solvency or on the verge of insolvency and it is the creditors’ money which is at risk”<sup>40</sup>, and where an action by directors would put at “real (as opposed to remote) risk” creditors’ prospects of being paid.<sup>41</sup> In *HLC Environmental Projects* the second formulation was presented as shorthand for the first, but it seemed to go further, for in most entrepreneurial projects there will multiple points at which creditors could be said to be at “real risk” of not being paid, though the enterprise would not yet be said to be “on the verge of insolvency”, at least if these phrases were given their colloquial meaning. *Secondly*, it has not been entirely clear what the rule requires when creditor interests compete with shareholder interests. Some cases suggest that the former must be treated as paramount<sup>42</sup>, while others suggest that something more like a weighing or balancing of interests is required.<sup>43</sup> This difference of approach does not seem to simply reflect differences in the formulation of the trigger for the application of the rule: as I have noted elsewhere, some judges have required creditor interests to be treated as paramount not only in insolvency but also its vicinity, while others have posited

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<sup>33</sup> See van Zwieteren (nx) at xx and xx, surveying the authorities.

<sup>34</sup> *ibid* xx.

<sup>35</sup> *Re HLC Environmental Projects Ltd (in liq)* [2014] B.C.C. 337, [99], van Zwieteren (nx) x.

<sup>36</sup> See van Zwieteren (nx) x.

<sup>37</sup> As has been noted by others, including Andrew Keay: see e.g. Andrew Keay, ‘Formulating a Framework for Directors’ Duties to Creditors: An Entity Maximisation Approach’ (2005) 64(3) CLJ 614; AR Keay, ‘Directors’ duties and creditors’ interests’ (2014) 130 (July) LQR 443.

<sup>38</sup> *Bilta (UK) Ltd (in liquidation) v Nazir (No 2)* [2016] A.C. 1.

<sup>39</sup> *ibid* at [123] per Lords Toulson and Hodge.

<sup>40</sup> *Colin Gwyer & Associates Ltd v London Wharf* [2003] BCC 885, [74].

<sup>41</sup> (nx) [89].

<sup>42</sup> *Colin Gwyer* (nx), and the other authorities cited in van Zwieteren (nx) fnx.

<sup>43</sup> *Goldtrail Travel Limited (in liquidation) v Aydin* [2015] 1 BCLC 89, [115] and the other authorities cited in van Zwieteren (nx) fnx.

shareholder interests being considered alongside creditor interests in insolvency as well as its vicinity.<sup>44</sup>

At first instance in *Sequana* it seems to have been common ground between the parties that:

“the content of the duty – whether it is to give paramount consideration to the interests of creditors or only to take their interests into account in some lesser way – does not vary according to the degree of risk of insolvency that has arisen”.<sup>45</sup>

But the parties did not agree on when the rule was enlivened. Counsel for the directors argued that the *West Mercia* rule would be engaged only where the company was “very close” to insolvency, while the claimants contended that “it is enough if there is a real, opposed to a remote, risk of insolvency”.<sup>46</sup> Rose J surveyed the authorities and concluded that in those cases in which something short of insolvency had been accepted to suffice, the companies had been “insolvent or very close to collapse”.<sup>47</sup> A test of “real (as opposed to remote) risk of insolvency” was on a literal reading lower than a test of being of “marginal” or “doubtful” insolvency, and the authorities did not provide support for it:

“That is not what the cases say and there is no case where, on the facts, the company could not also be accurately described in much more pessimistic terms, as actually insolvent or “on the verge of insolvency”, “precarious”, “in a parlous financial state”, etc”.<sup>48</sup>

On the facts the case was very different to those in which *West Mercia* had been applied:

“[The company’s balance sheet showed no deficit of liabilities over assets and there were no unpaid creditors knocking at [its] door. It was not in the downward spiral of accumulating trading losses, with no income and no prospect of any income that is typical of the companies where the duty has been held to have arisen”.<sup>49</sup>

The mere fact that it was possible that the contingent liability would turn out to be larger than the provision made for it was not a reason for applying the duty-shifting rule, for “that would result in directors having to take account of creditors’ rather than shareholders’ interests when running the business over an extended period”.<sup>50</sup> The point of the rule was to constrain directors from pursuing shareholder interests after the point in time when “a long term view is unrealistic”.<sup>51</sup> To hold that the rule applied simply because there was a real risk that the provision for a long-term liability would turn out to be inadequate would go well beyond this, and there was “no justification in principle for such a change”.<sup>52</sup> As such, the judge found that the rule was not engaged at the time the dividends were authorised.

The Court of Appeal dismissed the appeal against this finding. David Richards LJ, with whom Henderson LJ and Longmore JJ agreed, concurred with Rose J that a test of “a real, as opposed to remote, risk of insolvency” was a test with a “significantly lower threshold than being on the verge of insolvency or likely to become insolvent”.<sup>53</sup> The authorities did not provide

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<sup>44</sup> van Zwieten (nx) fn 39.

<sup>45</sup> (nx) [462].

<sup>46</sup> *ibid* [464].

<sup>47</sup> *ibid* [474].

<sup>48</sup> *ibid* [477].

<sup>49</sup> *ibid* [478].

<sup>50</sup> *ibid* [479].

<sup>51</sup> *ibid* [478], citing *Roberts v Frohlich* [2011] EWHC 257 (Ch).

<sup>52</sup> *ibid* [479].

<sup>53</sup> (nx) [214].

support for it, nor was a relaxation of the law to encompass the test with the lower threshold desirable, given the risk that it would unduly chill entrepreneurial risk-taking by honest directors, a risk that Parliament appeared to have been alive to in the drafting of various creditor-protective provisions of the Companies Act.<sup>54</sup> In all the English cases in which the rule had been applied, the company in issue appeared to have been insolvent at the relevant time, and directors either knew or ought to have known that.<sup>55</sup> But judges had consistently assumed that something less than actual insolvency sufficed,<sup>56</sup> and one advantage of this approach was that it accommodated cases in which “the descent into insolvency may be more gradual”, such that directors “may often not know, nor be expected to know, that the company is actually insolvent until some time after it occurred”.<sup>57</sup> This suggested that a test falling short of actual insolvency was justified, but a temporal formulation like “on the verge of insolvency” was perhaps too narrow, for it would not capture cases in which:

“although the company may be able to pay its debts as they fall due for some time... insolvency is none the less likely to occur and decisions taken now may prejudice creditors when the likely insolvency occurs”.<sup>58</sup>

The preferable formulation was when the company was “insolvent or likely to become insolvent”, with “likely” being treated as more probable than not.<sup>59</sup> It was not necessary to decide whether, where the rule is engaged, it requires creditor interests to be treated as “paramount”. But “where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors’ interests could be anything but paramount”.<sup>60</sup>

It seems to me that the Court of Appeal was right to reject the “real, as opposed to remote, risk of insolvency” test. To embrace it would have involved expanding the operation of the rule (as both the first instance and Court of Appeal decision make clear, the preponderance of authority suggested a more restrictive approach, in which the rule would not be enlivened unless the company was insolvent or bordering on insolvency), and such an expansion does not seem desirable: a duty-shifting rule enlivened wherever there is a “real risk” of creditors not being paid, even if insolvency is not yet more probable than not, could well make honest directors of struggling debtors too risk adverse, such that opportunities to maximise value for the benefit of the company’s stakeholders are abandoned.<sup>61</sup> At the same time, I agree that restricting (as courts in Delaware have done)<sup>62</sup> the duty-shifting rule to factual insolvency is unattractive. This would require the precise point in time when insolvency arrived to be pinpointed before personal liability for breach of a creditor-regarding duty could arise, even though the rationale for duty-shifting – that creditor interests must come to the fore when a long-term view is no longer realistic<sup>63</sup> – seems engaged wherever it is more probable than not that the company will

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<sup>54</sup> (nx) [215], [193]-[195], [209]-[210].

<sup>55</sup> *ibid* [195].

<sup>56</sup> *ibid*.

<sup>57</sup> *ibid* [218].

<sup>58</sup> *ibid* [219].

<sup>59</sup> *ibid* [220].

<sup>60</sup> *ibid* [222].

<sup>61</sup> This is the argument against duty-shifting rules made by Hu and Westbrook in their well-known paper ‘Abolition of the Corporate Duty to Creditors’ (2007) 107 *Columbia Law Review* 1321. Hu and Westbrook advocate the abolition of the Delaware duty-shifting rule altogether, but they do so by focusing on the position of directors in publicly traded companies, rather than those in closely held companies, and it is arguable that there is a greater need for a duty-shifting rule in the latter than the former.

<sup>62</sup> *North American Catholic Education Programming Foundation Inc. v Gheewalla* 930 A.2d 92 (Del 2007).

<sup>63</sup> Above, text to nx.

prove unable to pay its debts. If the company's prospects improve and creditors are able to be paid in full, then they will not have a basis on which to complain of a breach of duty.

It is a pity that the Court of Appeal did not resolve the question of what the duty-shift requires of affected directors, but the suggestion that creditors' interests must be treated as paramount when the company is actually insolvent seems plainly correct. If it is clear that creditors have become the residual claimants, then their interests should be treated as paramount. It is more difficult to work out what the position should be when insolvency is not yet inevitable but does appear likely (i.e. more probable than not). A 'bright line' rule that creditors' interests are to be treated as paramount at every stage would be easier to apply than one that requires directors to weigh or balance competing interests. Yet such a rule would also require directors to disregard the interests of shareholders in circumstances where they retain a real economic interest in the firm (because the company is not yet insolvent). This suggests that a 'sliding scale', in which something less than paramountcy is required when creditors are not yet certain to be the residual claimants, is preferable to a 'bright line' rule.

In practice, *West Mercia* has tended to be applied not to police conflicts between the interests of creditors and those of shareholders, but rather to police intra-creditor conflicts.<sup>64</sup> In particular, *West Mercia* has been used to provide a remedy in cases in which some creditors complain of being left unpaid while others were paid in full, outside the ordinary course of business, in the lead-up to the commencement of insolvent liquidation. *West Mercia* was itself such a case: in issue there was the decision of a director to authorise the payment of an unsecured debt owed by the company to its insolvent parent by payment into the overdrawn bank account of the parent; the director had personally guaranteed the parent's debt to the bank, and the objective was to reduce his liability under this guarantee. The Court of Appeal held that the director had breached a fiduciary duty owed to the subsidiary in arranging the payment for his own benefit, "in disregard of the interests of the general creditors", in circumstances where the subsidiary was already, to his knowledge, insolvent.<sup>65</sup> The director was ordered to repay the amount paid, subject to a discount designed to ensure that unsecured creditors were not put in a better position than they would have been had the payment not been made.<sup>66</sup> As I have charted elsewhere, there are at least four cases in which *West Mercia* has been applied in the same way, to secure a remedy for unsecured creditors aggrieved by the decision of directors to self-interestedly arrange payments to creditors in the lead-up to the commencement of insolvent liquidation.<sup>67</sup> Such payments will typically be voidable as preferences, but *West Mercia* offers an alternative route to a remedy by targeting the directors who self-interestedly authorised their payment.

As Newey J explained in *GHLM v Maroo*, it is not difficult to conclude that "a director who acts to advance the interests of a particular creditor, without believing their action to be in the

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<sup>64</sup> Van Zwieteren, nx. As I noted in this paper (at text to nx), the rule has also been applied in cases involving the gifting of corporate assets to non-creditors in the lead up to the commencement of insolvency proceedings. But no recourse is needed to *West Mercia* to conclude that such gifting involves a breach of duty by company directors. The contribution made by *West Mercia* is to clarify that the breach cannot be authorised or ratified by shareholders.

<sup>65</sup> (nx) 33.

<sup>66</sup> If the director was simply ordered to pay in what had been paid out, unsecured creditors would have been better off, for the debt to the bank would remain discharged: van Zwieteren (nx) x.

<sup>67</sup> See van Zwieteren (nx), discussing *Re City Span Ltd* [2008] B.C.C. 60, *HLC Environmental Projects* (nx), *Re Micra Contracts Ltd* [2016] B.C.C. 153, *Re Cosy Seal Insulation Ltd (in administration)* [2016] 2 B.C.L.C. 319.

interests of the creditors as a class, acts in breach of duty”<sup>68</sup>. Directors owe a duty to act in good faith to promote the success of the company<sup>69</sup> (previously expressed as the duty to act *bona fide* in the interests of the company). Where the company is insolvent or (applying *Sequana*) likely to become insolvent, “the company” must be understood by reference to the interests of the creditors “as a class”<sup>70</sup>, rather than by reference to the interests of shareholders (as a class). A decision to advance the interests of one creditor ahead of others, without believing the action to be in the interests of creditors as a class, would be a breach of this duty.<sup>71</sup> The difficulty, as Newey J pointed out, is in relation to remedy. The duty is owed to the company, not to creditors, with the result that there can be no compensation for the breach, for the payment of a preference causes no loss to the company. Where (as in the case of the duty to promote the success of the company) the duty is a fiduciary one, a gain-based remedy might be available,<sup>72</sup> but as I have suggested elsewhere, it will not necessarily always be easy to work out the extent to which a director has profited from the payment of a preference<sup>73</sup>. The solution hit on by another judge in a different case, *HLC Environmental Projects*,<sup>74</sup> was to impose a restorative remedy, by analogy with the position of a defaulting trustee:

“The liability of a defaulting fiduciary who has, by his or her default, allowed the trust fund to become denuded is, or includes, a liability to restore the fund to what it should have been”.<sup>75</sup>

If accepted, this reasoning means that directors can be made personally liable in circumstances where they self-interestedly authorise the payment of preferences, notwithstanding that s.214 (being restricted to compensation for loss to the company) is unavailable. This option would, however, disappear if courts come to disapprove of the remedial restorative analysis deployed in *HLC*.<sup>76</sup>

### III. The compensation order regime

Prior to 2015, directors could be disqualified by application of the Company Directors Disqualification Act 1986, but could not be made liable to compensate the company (or anyone else) under that Act. Engaging in ‘wrongful trading’ contrary to s.214 was a ground for disqualification<sup>77</sup>, but if compensation for loss caused by wrongful trading was sought, then an action had to be brought by the office-holder under the Insolvency Act 1986 to secure this. In 2015, this position was altered by the introduction of ss.15A-B to CDDA 1986, which empowered courts to impose “compensation orders” on directors disqualified under the Act. The explanation given for the change was a concern that the personal liability provisions of the Insolvency Act 1986 and Companies Act 2006 were being under-enforced, while the disqualification regime in the CDDA 1986 was much more commonly used: “the aim would be to increase the likelihood of culpable directors being called to account for their actions, while providing better recourse to funds for creditors who have suffered”.<sup>78</sup>

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<sup>68</sup> (nx) [168].

<sup>69</sup> Section 172(1) of the Companies Act 2006.

<sup>70</sup> (nx) [168]; see also above, text to nx.

<sup>71</sup> *GHLM v Maroo* (nx) [168]. See also *Re Micra Contracts* (nx) [82].

<sup>72</sup> (nx) [169].

<sup>73</sup> (nx) x.

<sup>74</sup> (nx).

<sup>75</sup> *ibid* [142].

<sup>76</sup> As to which, see further van Zwieten (nx) x-x.

<sup>77</sup> Company Directors Disqualification Act 1986 s.10.

<sup>78</sup> *Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business* (Department for Business, Innovation and Skills, Discussion Paper, July 2013, [11.13], as noted in *Noble Vintners* (nx) at [16].

It is not easy to work out whether the rules imposing personal liability on directors were under-enforced. As Paul Davies has put it, “the level of reported cases and the impact of any particular law is complex and not by any means unilinear”.<sup>79</sup> The mere fact that there have been, for example, relatively few wrongful trading cases brought since 1986<sup>80</sup> does not mean that directors have been escaping liability for failing to take every step with a view to minimising loss to creditors once they know or ought to know that insolvent liquidation is inevitable. They may have taken those steps, or – if they did not – their acts or omissions may have caused no loss to the company (as in *Ralls*). In any case, the Government did not merely decide to give the Secretary of State standing to pursue wrongful trading actions under the CDDA 1986. Instead, a new stand-alone compensation order regime was introduced, with a very different scope to anything that was available against directors under the old law.

Section 15A gives the court power, on an application by the Secretary of State, to make a compensation order against a person who has been disqualified under the Act where the conduct for which they were disqualified “caused loss to one or more creditors of an insolvent company of which the person has at any time been a director”.<sup>81</sup> The focus is on loss being caused *to creditors* rather than the company, and as a corollary the court is expressly empowered to order that compensation be paid not only to the company, but also to a creditor or creditors or class or classes of creditor.<sup>82</sup> There is no power to make such an order under s.214 or *West Mercia*: the former is concerned with loss caused to the company, and so the court is empowered only to order a contribution to the assets of the company; the latter is concerned with breaches of duty owed *to the company* such that there could be no power to order compensation for loss caused to individual creditors. This was rightly described as a “radical” change by ICC Judge Prentis in *Re Noble Vintners Limited*<sup>83</sup>, the first case on the interpretation of the new provisions.

As Judge Prentis noted in *Noble Vintners*, one of the effects of the change is that there is now a straightforward route to recovering compensation in relation to losses caused to unsecured creditors by directors who self-interestedly conduct a ‘mini-liquidation’ in the lead-up to the commencement of insolvency proceedings.<sup>84</sup> Since the CDDA compensation regime focuses the court’s attention on loss caused “to one or more creditors”, rather than loss to the company, and empowers it to direct compensation be paid to select creditors rather than the company, there should be no difficulty with using these provisions to secure compensation for unsecured creditors in a *West Mercia*-type case. In *Noble Vintners* Judge Prentis sensibly concluded that the loss that could be compensated for under the new CDDA regime in relation to the payment of a preference was the difference between what the aggrieved creditor received and what they would have received had the director not engaged in “discriminatory treatment”.<sup>85</sup> The same approach has been taken in *West Mercia* cases, with courts discounting the amount that directors are liable to restore to the company to reflect the fact that had the payment not been made, the unsecured creditors would have had to share in any assets on a *pro rata* basis with

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<sup>79</sup> (nx) x.

<sup>80</sup> See R Williams, ‘What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?’ (2015) 78(1) *Modern Law Review* 55.

<sup>81</sup> S.15A(1)(b).

<sup>82</sup> S.15B(1).

<sup>83</sup> (nx) [24].

<sup>84</sup> *ibid* [24].

<sup>85</sup> *ibid* [36].

the payee.<sup>86</sup> This suggests that the court will be able to reach a similar result under the CDDA to that which has been reached in the *West Mercia* line of cases<sup>87</sup>, side-stepping the remedial difficulties associated with the latter.

Yet the new CDDA regime goes much further than this. The Act introduces new complexity to every case in which directors are already exposed to the risk of personal liability under the Insolvency Act 1986 and Companies Act 2006. Compensation may now be obtainable under the CDDA as well as under the Insolvency Act 1986 and Companies Act 2006, but in the former case compensation can now be ordered payable to a select group of creditors, rather than for the benefit of the class. Consider, for example, a case in which a director has authorised the company's entry into a transaction at undervalue in breach of duty (of which *Noble Vintners* seems an example). Under the old law, the recipient could be targeted using s.238 of the Insolvency Act 1986, and the director could be targeted in a misfeasance action under s.212. In either case recoveries would accrue for the benefit of the company as a whole<sup>88</sup>. Under the new law, there is an additional power to order that recoveries be paid to some creditors over others. The decision for officeholders on whether to pursue an action under the old law or recommend disqualification and an associated compensation order does not seem an easy one<sup>89</sup> (increasing direct costs), and a court asked to make a selective order has a more complex (and therefore more costly) task on its hands than under the old law<sup>90</sup>. If it were obvious that a transaction at undervalue always prejudices pre-transaction creditors more than post-transaction creditors, then there might be a case for the change notwithstanding these costs. But this does not seem obvious to me.

Moreover, it seems possible for compensation to be ordered under the CDDA even in circumstances where it would *not* be obtainable under the old law (i.e. in circumstances where directors would not be personally liable under the Insolvency Act 1986 or Companies Act 2006). Consider, for example, a case like *Ralls*, in which a director is found to have engaged in 'wrongful trading' (by failing to make out the defence under s.214(3)) but is not liable to pay compensation under s.214, because their conduct caused the company no loss. If a court was satisfied that such conduct rendered a person unfit to be concerned with the management of a company within the meaning of s.6 of the CDDA, then they could be disqualified<sup>91</sup>, opening up the possibility of an application for a compensation order in relation to conduct that would not be compensable under s.214 i.e. loss to a particular creditor or creditors. I have already explained why I would be cautious about making directors personally liable in relation to the payment of factual preferences in circumstances where the preference can reasonably be regarded as incidental to the taking of action to maximise the value of the debtor's estate, and there is no suggestion that the directors acted dishonestly. As such, I do not think it would be desirable if the CDDA could be used to circumvent s.214 in this way. There may of course be

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<sup>86</sup> Above, text to nx.

<sup>87</sup> Whether it is the same will depend on how the composition of the creditor body has changed since the giving of the preference. *West Mercia* takes a "snapshot" of the company's position at the time of the wrongdoing, and requires the director to restore the moneys paid out at that time, with the benefits accruing to those who remain unsecured creditors at the time of the commencement of insolvency proceedings. The CDDA focuses directly on the position of the latter.

<sup>88</sup> Albeit that recoveries under s.238 would not be susceptible to capture by a creditor with an after-acquired property clause, and recoveries under s.212 (as an action brought in right of the company) are: see Goode, nx.

<sup>89</sup> van Zwieten (nx).

<sup>90</sup> As I think is clear from *Noble Vintners*, in which the judge distinguishes between groups of creditors on the basis of how directly they were affected by the wrongdoing.

<sup>91</sup> The analysis in Adrian Walters and Malcolm Davis-White, *Directors' Disqualification & insolvency Restrictions* (3<sup>rd</sup> ed) (2009 Sweet and Maxwell) at para.[5-05], suggests this is not implausible.

cases in which it is desirable to expand the scope of directors' personal liability, but even here the benefits of doing so through the CDDA – with its uncertain, potentially very wide, scope – must be weighed against the fact that directors now have less considerably weaker incentives to offer disqualification undertakings than they did before 2015<sup>92</sup>, with all the costs associated with this.

## Conclusion

Viewed in isolation, s.214 seems unattractively narrow, for it provides no solution in a case in which directors self-interestedly pay some creditors ahead of others in anticipation of the commencement of insolvency proceedings. If s.214 were all we had, I would agree with Professor Moss<sup>93</sup> that a change – either in the interpretation of the section, or (more likely, given the relatively settled state of the law on its interpretation) by legislative amendment – would be warranted. Fortunately, the judge-made duty-shifting rule filled the gap, providing a workable (if remedially somewhat difficult) solution in cases involving self-interested preferences. Parliament's new innovation – the compensation order regime in the CDDA 1986 – provides a more straightforward route to the same result in such cases. But it also goes much further, complicating the remedial inquiry in cases where a remedy would be available as a matter of course outside the CDDA, and expanding the grounds on which directors can be made personally liable. This goes well beyond the stated rationale for the reform (under-enforcement of the old law). I fear that the costs of this change may exceed the benefits.

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<sup>92</sup> As noted by the judge in *Noble Vintners* at [54].

<sup>93</sup> (nx).