Directors’ duties post insolvency

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Abstract:

The extent and scope of directors’ duties post insolvency are examined. Considers the general duties of directors and the continuing obligations that directors owe to creditors and stakeholders. The article also considers the implications of COVID-19 and argues that this will have far-reaching consequences on directors.

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Introduction

There appears to be a common assumption among company directors that their duties cease at the point of insolvency.[2] While it is true that there is limited reference to caselaw and commentaries dealing with directors' duties post insolvency,[3] the lack of authority on the subject should not suggest that "the dog did not bark".[4] To the contrary, the lack of caselaw and commentary may simply reflect, for the most part, that licensed insolvency practitioners are highly effective in fulfilling their obligations. To that end, the silence on the matter should not infer that directors do not have continued responsibilities to various stakeholders both in a solvent environment and during a formal insolvency; in fact, such duties have a long heritage.[5] The recent decision in *Re System Building Services Group Ltd; Hunt v Michie* [2020] EWHC 54 (Ch), provides for some much needed judicial attention in regard to directors' duties and whether they apply post insolvency.

The article subsists of three parts. First, the general assumption associated with directors' duties will be examined with reference to *Re System Building Services Group Ltd*. Second, the general duties owed by directors will be explored in line with post insolvency obligations. Third, the implications that post insolvency obligations will have on directors will be explored in conjunction with what consequences COVID-19 and the Corporate Insolvency and Governance Act 2020 ("CIGA 2020") will have on these duties. This article will conclude that the obligations expected of directors not only fail to cease at the point of insolvency but are in fact enhanced and are likely to come under greater scrutiny in light of the pandemic.

The general assumption

The opportunity to provide clarity on the extent to which directors' duties apply presented itself in the recent decision of the English Insolvency and Companies Court, *Re System Building Services Group Ltd; Hunt v Michie* [2020] EWHC 54 (Ch). The facts in this case are relatively straightforward. Mr Michie was the sole director and shareholder of System Building Services Group Limited – a passive fire protection company that went into administration on 12 July 2012, at which point Mrs Sharma was appointed as liquidator. The company subsequently exited administration and entered a company voluntary liquidation on 3 July 2013, before being dissolved on 24 February 2016. In 2014, Mr Michie purchased a property for £120,000 from the company, Mrs Sharma acting as liquidator. In a separate unrelated matter Mrs Sharma was found liable for misfeasance, made bankrupt and was ultimately replaced by Mr Hunt. Upon investigation Mr Hunt alleged that Mr Michie had breached his fiduciary duties in two regards. First, property was purchased at a substantial undervalue, for Mr Michie's own benefit and without regard to the interests of the creditors as a whole, and second, a series of payments were paid out of the company's bank account

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[2] The principles of section 123 of the Insolvency Act 1986 in terms of the definition of an inability to pay debts as they fall due are well known. This section provides that insolvency can be assessed on either a cash flow or balance sheet basis. The application of these provisions was addressed by the Supreme Court in *BNY Corporate Trustee Services Ltd v Eurosail-UK plc* [2013] 1 BCLC 613.

[3] For example, see *McTear v Engelhard & Ors* [2014] EWHC 1056.

[4] *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch), para [57].

[5] See J. Tribe, 'The role of directors in receivership: who should bring actions for loss suffered by the company and defend any counterclaim?' (2001) 4(4) *Receivers, Administrators and Liquidators Quarterly* 335.

to a third party shortly after the company's entry into administration. Both issues concern the actions of the director and whether they constitute a breach even after insolvency has occurred.

From the offset it is important to note that while *Re System Building Group Limited (In Liquidation)* is a first instance decision, it nevertheless remains significant. It is likely that ICC Barber's commentary in this case will have far reaching consequences on directors who trade companies in administration, with special consideration attached to decisions made during the pandemic. Further implications are also likely for pre-packaged administrations where directors may contemplate and facilitate the process with a liquidator or administrator. Creditors generally are likely to question the decisions made by directors when the company was likely to enter insolvency and during the COVID-19 window, with specific focus on whether the directors have taken the creditors' interests as a whole into account.[6] The type of decisions under scrutiny would include any that would lead to possible action being taken against the director, such as breach of the general duties, fiduciary duties, and possibly other duties.[7] In regard to the duty to act in the interests of creditors of the company this can be classified as a non-fiduciary in nature, at least in cases where the director is not engaged in self-dealing.[8] However, if a breach of the duty to consider the interests of creditors falls into the category of a "breach of trust", then the courts have tended to interpret such a breach as a fiduciary duty in a corporate context.[9] The consequence of such a duty being identified as fiduciary in nature would result in possible restorative orders, but this appears inconclusive based on the caselaw.[10] Nonetheless where the approach is certain is in instances where a director commits fraud which has public effects. In these cases, there is not only no relief, but fraud committed against the creditors will also breach both the director and fiduciary duties,[11] as well as raise serious public policy considerations.[12]

Given the importance of the directors' duties it is somewhat of a surprise that there is a general assumption amongst directors that their powers are confined. This assumption is likely to be the result of paragraph 64 of Schedule B1 of the Insolvency Act 1986, which provides that "a company in administration or an officer of a company in administration may not exercise a management power without the consent of the administrator". For the purpose of paragraph 64, no officer of the company may exercise "management power" so as to "interfere with the exercise of the administrator's powers", without the consent of the administrator.[13] In addition, not only do the administrators have that power of consent to

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[6] See *GHLM Trading Ltd v Maroo* [2012] 2 BCLA 369, para [168]; *Capital for Enterprise Fund A LP v Bibby Financial Services Ltd* [2015] EWHC 2593 (Ch), para [89].
[7] This would include preferential payments, see A Keay, 'Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests' (2020) 136 *L.Q.R.* 52-76.
[8] K van Zwieten, "Director Liability in Insolvency and Its Vicinity" (2018) 38 *O.J.L.S*. 382, at 402.
[9] See, A Keay, 'Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests' (2020) 136 *L.Q.R.* 52, at 72.
[10] *AIB Group (UK) Plc v Redler* [2014] UKSC 58; [2015] AC 1503.
[11] *Liquidator of West Mercia v Dodd* (1988) 4 BCC 30, at 33.
[12] A Keay, 'Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests' (2020) 136 *L.Q.R*. 52, at 73.
[13] See paragraph 64(2)(a) of Schedule B1 of the Insolvency Act 1986.

further the objective of the administration but they can also, if required, remove and appoint an officer and call a meeting of members to seek a decision on any matter from the company's creditors.[14] Yet, while an administrator would thereby primarily be responsible for the management of the company's affairs, business and property, directors may remain in office and even with restricted powers, which may be enhanced through the consent of the administrator,[15] are nonetheless still under an obligation to abide by their statutory and common law duties.[16] To hold otherwise would be to ignore the development of the common law. In substance it was established in *The Charitable Corporation v Sutton* (1742) that a director of a company owes duties to the company in the same measure and quality as does a trustee to a trust.[17] The importance of this was articulated by Lord Hardwicke in his judgment where be held that because the directors were agents of the people who grant them power to manage the corporation's affairs, they would be liable for any negligent acts or omissions.[18] The case acted as a useful reminder to judges not to be quick to evaluate the decisions of directors with hindsight. Instead, it would be deemed necessary to refer to conduct and professional principles to act as benchmarks so that acceptable directorial standards can be properly established.[19] The ensuing cases and development of equitable principles soon formed the foundations for the duties which company directors were expected to adhere. These duties were largely subsequently codified in the Companies Act 2006, with the purpose to streamline the existing common law and provide an accessible 'rule book' for directors of companies.

Since *Re System Building Group Limited (In Liquidation)* concerned director misconduct, ICC Barber took the step to examine the directors' general duties under sections 171-177 and confirmed that they did continue to apply notwithstanding commencement of administration or creditors' voluntary liquidation. ICC Barber explained that "those duties [were] independent of and run parallel to the duties owed by the administrator or liquidator appointed in respect of the company".[20] As such, in procuring and agreeing the sale of a freehold property from the company's administrator to the director at a time when he knew the company was insolvent, the director had acted entirely out of self-interest and failed to have regard to the interests of the creditors as a whole.[21] In such circumstances, to establish whether the creditors interests as whole were properly considered, the objective test is applied.[22] The objective test requires that the court ask itself whether an intelligent and honest man in the position of a director of the company could, in the circumstances, have reasonably believed that the transaction was for the

[14] See paragraphs 61-62 of Schedule B1 of the Insolvency Act 1986.
[15] *Re ASA Resource Group Plc* [2020] EWHC 1370 (Ch) paras [26] [30] [31].
[16] *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch), para [55].
[17] 26 ER 642.
[18] 26 ER 642, at 644.
[19] For example, under section 172 of the Companies Act 2006, courts should not interfere with the board's decision concerning an alleged breach of the duty to promote the company unless it is one that no reasonable director could have made. See, P. Davies and S. Worthington *(eds), Gower and Davies: Principles of Modern Company Law* (9th edn, Sweet & Maxwell, 2012), para 16-76.
[20] *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch), para [39].
[21] *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch), para [117].
[22] *Re HLC Environmental Projects Ltd, Hellard v Carvalho* [2013] EWHC 2876 (Ch) (at [91] – [93]); see also, *Wow Internet v Qasim Majid* [2020] EWHC 2890 (Ch), para [34].

benefit of the creditors as a whole. On the facts, it was clear to ICC Barber that the answer was to be plainly "no".[23] Since the objective test failed, the director was found to be in breach of his fiduciary duty under section 172(3) of the Companies Act 2006 as he had "allowed the level of his conduct to drop to 'that trodden by the crowd'…".[24] This delightful term was borrowed from Cardozo CJ in *Meinhard v Salmon,* which highlights that the level of integrity expected by directors far exceeds that compared to non-directors due to the fiduciary duties they have to the company and its members.[25] The exact extent and scope of director duties will now be explored.

The directors' general duties

The general duties of a director are relatively well known and are set out in ss.171 to 177 of the Companies Act 2006, with the main ss.171, 172, 174 and 175 being discussed here since they are the most common duties that are disputed in post insolvency cases. Such disputes often concern what directors should have done at certain stages leading up to and after the point of insolvency. Instead of diminished obligations the duty to creditors owed by directors at the point of insolvency are in fact enhanced.[26] That is not to say that the duty towards creditors should be seen as a new or an additional obligation,[27] nor does it impose a new duty owed to the company.[28] Instead, the existing duties are altered and given relevance to a post insolvency perspective with regard to creditors, viewed as a class or as a whole.[29] In essence, the hallmark of these fiduciary duties is to act in the interests of and show loyalty to the company.[30] As such the importance to abide by the general duties survive even when other obligations have been temporary suspended.[31]

Broadly construed s.171 provides that a director of a company must act in accordance with the company's constitution and may only exercise powers for the purposes for which they are conferred. The extent of these powers is subject to the company's articles and any directions given by the shareholders by special resolution.[32] In return the directors are "responsible for the management of the company's busines for which purpose

[23] *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch), para [117].
[24] *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch), para [120].
[25] (1928) *164 NE 545*, at 546.
[26] *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30; *Re HLC Environmental Projects Ltd, Hellard v Carvalho* [2014] BCC 337; *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, para [195].
[27] See K van Zwieten, 'Director liability in insolvency and its vicinity' (2018) 38(2*) Oxford Journal of Legal Studies* 382, 387 and 400, surveying the authorities.
[28] K van Zwieten, 'Disciplining the directors of insolvent companies' (2020) 33(1) *Insolv. Int*. 2, 5.
[29] K van Zwieten, 'Director liability in insolvency and its vicinity' (2018) 38(2) *Oxford Journal of Legal Studies* 382, 388.
[30] See *Northampton Borough Council v Cardoza* [2019] BCC 582, para [119].
[31] For example, see the temporary suspension of wrongful trading under section 12 of the Corporate Insolvency and Corporate Governance Act 2020; and The Corporate Insolvency and Governance Act 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and Extension of Relevant Period) Regulations 2020 (the "Regulations").
[32] See The Companies (Model Articles) Regulations 2008, SI 2008/3229, reg 2, Sch 1, art 4 (Ltd); reg 4, Sch 3, art 4 (Plc).

they may exercise all the power of the company".[33] Much of the commentary on this point focuses on the scope of this power given to the directors by the constitution and the implications when they ignore or breach the terms, whether collectively or individually.[34] It must be noted that a lack of authority and the exercise of authority for an improper purpose are distinct issues as s.171 of the Companies Act 2006 makes clear. Yet there is an overlap between them which brings much needed coherence to this section, but the opportunity to expressly state this in the framework was not taken. The overall picture remains complex, but a coherent framework has emerged based on agency law.[35]

Section 172 provides that 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. A duty under s.172 exists regardless of whether any specific provisions in the Insolvency Act 1986, such as ss.238 (undervalue) and 239 (preferences) are in point.[36] The article does not discuss these provisions further as the focus is on director duties, and unlike undervalue and preferences, the application of general duties post insolvency has received limited commentary.[37] Yet it is the reliance on s.172 that provides an advantage since s.172(3) provides that the duties imposed by ss.172(1) and (2) are in effect "subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company".[38] There is no time limit to this duty, unlike preferences (two years) so the general duty effectively extends the reach of the liquidator beyond the periods prescribed by the Insolvency Act 1986.[39] As such even though the court has found an act like wrongful trading and a breach of duty may arise in respect of the same period of time,[40] it is doubtful since s.172(3) comes into play at an earlier stage that s.214 of the Insolvency Act 1986.[41] To better appreciate how effective s.172 remains it is necessary to examine the recent case of *Sequana*.[42] At common law, directors were under the duty to act bona fide in what was considered the interests of the company, understood to mean consideration given to both

[33] See The Companies (Model Articles) Regulations 2008, SI 2008/3229, reg 2, Sch 1, art 3 (Ltd); reg 4, Sch 3, art 3 (Plc).
[34] B Hannigan, '*Company Law*' (5 edn, OUP: 2018), at 185.
[35] See *Criterion Properties plc v Stratford UK Properties LLC* [2006] 1BCLC 729; J Payne and D Prentice, 'Company contracts and vitiating factors: developments in the law on directors' authority', (2005) 4 *L.M.C.L.Q.* 447, at 455.
[36] Section 172(3) exists independently of any claim under s239 of the Insolvency Act 1986, see *GHLM Trading Ltd v Maroo* [2012] 2 BCLC 369, para [168].
[37] For a detailed discussion on directors' obligations in regard to preferences post insolvency, see A Keay, 'Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests' (2020) 136 *L.Q.R.* 52-76.
[38] See *Re HLC Environmental Projects Ltd, Hellard v Carvalho* [2014] BCC 337. For a critical examination of the duty to account for creditors' interests, see A Keay, 'Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests' (2020) 136 *L.Q.R.* 52-76.
[39] *GHLM Trading Ltd v Maroo* [2012] 2 BCLC 369, para [168].
[40] *Roberts v Frohlich* [2011] 2 BCLC 625.
[41] See R Werdnik, 'Wrongful Trading Provision – is it Efficient?' (2012) 24 *Insolv. Int.* 81, at 82.
[42] *BTI2014LLC v Sequana* [2017] 1 BCLC 453.

the short term and long term interests of shareholders as a general body.[43] The duty has been modified to include the interests other than for the benefit of its members, namely creditors.[44] This would appear in line with considering the interests of the company, to the point that the courts have developed this duty to include within it the requirement for directors to have regard to the interests of creditors where the company is insolvent or of doubtful solvency and it is the creditors' money which is at risk.[45] Applied to insolvency it would be important to recognise that the duty to act in good faith is a subjective test, and as such it would be necessary to establish the director's state of mind and determine whether he acted in a way that he honestly considers, in good faith, would be most likely to promote the success of the company,[46] for the benefit of its members as a whole.[47] Deferring to the honest belief of the directors reflects the traditional view that the courts must not get involved in reviewing the exercise of business judgment by directors, and in particular scrutinising a situation with the benefit of hindsight.[48] However, should no evidence be provided to support the director's honest belief that he has considered a matter, that the interests of the company have been neglected,[49] or the decision was deemed to be unreasonable,[50] then these are likely to act as boundaries to the belief that the decision was in the interests of the company and its members. The term "success" in regard to insolvent or near insolvent companies would be understood to refer to the economic viability of the company, which would mean if the decisions taken were in good faith with the honest belief that they would promote the success of the company, then it is likely not to breach the duty.[51] That said, if both s.172 and s.214 (and now s.246ZB) co-existed, one or the other becomes redundant, and given the difficulties associated with applying s.214, the development of an "open-textured obligation under s.172(3) seems more attractive and effective".[52] The effect of *Sequana* has however potentially reversed this position as it applied "brink of insolvency" which has brough s.172 closer to s.214 thereby eroding some of the value of s.172(3).[53]

In regard to the appropriate skill expected of directors in the modern commercial world, s.174 provides that a director of a company must exercise reasonable care, skill and

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[43] *Re Smith & Fawcett Ltd* [1942] Ch 304, at 306.
[44] It is interesting to note that requiring directors, in certain circumstances, to consider or act in the interests of creditors is a provision which has its origins in influential Australian and New Zealand decisions, see *Walker v Wimborne* (1976) 50 ALJR 446; *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242.
[45] *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250.
[46] *Re Smith & Fawcett Ltd* [1942] Ch 304, at 306.
[47] See *Regentcrest plc v Cohen* [2001] 2 BCLC 80, at 105.
[48] See *Regentcrest plc v Cohen* [2001] 2 BCLC 80, at 105-107; *Facia Footwear Ltd v Hinchcliffe* [1998] 1 BCLC 218, at 228.
[49] *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598, at 619
[50] *Regentcrest plc v Cohen* [2001] 2 BCLC 80, at 120.
[51] For example, financial support from a subsidiary to help the survival of another within a group of companies is not only a common occurrence, but a decision that can be taken bona fide in the interest s of the company. See, *Facia Footwear Ltd v Hinchcliffe* [1998] 1 BCLA 218, at 225-226, 228-9; also see, *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360.
[52] B Hannigan, '*Company Law*', 5 edn (OUP: 2018), at 242.
[53] *BTI2014LLC v Sequana* [2017] 1 BCLC 453.

diligence interpreted from both a subjective and objective perspective.[54] The content of this duty was developed by the courts over a sustained period of time,[55] but whether they should be considered strictly common law duties or equitable duties has been a matter of some debate,[56] but it is now one that is largely immaterial since they are classified as statutory duties.[57] With the enactment of the Companies Act 2006 the objective test found in s.174(2)(a) mirrors that contained within the wrongful trading provision as stated in s.214(4) of the Insolvency Act 1986, which in the event of liquidation may encourage a liquidator to purse a director on this basis or for misfeasance in order to enforce the duty of care and skill. The application of wrongful trading, the recent case of *Manolete Partners Plc v Ellis*,[58] adopted the approach set out by Snowden J in *Gant v* Ralls,[59] which provided that a director should exercise an objective as opposed to a subjective view of the facts as to whether there was no reasonable prospect of the company avoiding liquidation. Such application should be conducted without that of hindsight and should avoid behaviour that could be stigmatised as “blind optimism” or “reckless belief”.[60] The approach compliments the essence of s.214(3) which aims to protect creditors after the relevant time, rather than the result by requiring directors to show that he took “every step…as he ought to have taken” with the “view to minimising” the potential loss to creditors, even if he does not actually succeed in his objective. To avoid liability by expressly taking “every step” creates a high threshold for directors to surmount, and this has been strictly applied.[61]

In response to COVID-19, CIGA 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and Extension of the Relevant Period) Regulations 2020, the courts are now required to assume that a director is not responsible for any worsening of the company’s financial position between 26 November 2020 and 30 April 2021. The temporary suspension was in part aimed to address the financial pressures on businesses created by the pandemic and to deal with the fear of personal liability for wrongful trading, which could cause directors to be too hastily to place the company into administration or liquidation; an effect that could intensify the damage to the economy. Further measures, such as the restrictions on presenting winding-up petitions and financial support through the Corona Job retention Scheme and the various government backed loan programmes are all likely to mask the extent of financial problems in certain companies. While the court has discretion whether to make a declaration of wrongful trading, the provisions state "shall" and might thus be mandatory.[62] It is also crucial to note that the suspension of wrongful trading does

[54] s.174(2)(a)-(b) of the Companies Act 2006.
[55] *Daniels* v. *Anderson* (1995) 37 N.S.W.L.R. 438 (NSWCA); *Re Barings plc (No. 5)* [1999] 1 BCLC 433; *Equitable Life* v. *Bowley* [2003] EWHC 2263 (Comm), [2004] 1 BCLC 180.
[56] See *Daniels* v. *Anderson* (1995) 37 N.S.W.L.R. 438 (NSWCA), *Lagunas Nitrate Co. Ltd.* v. *Lagunas Syndicate* [1899] 2 Ch. 392 at pp. 435, 437.
[57] See RC Nolan, ‘Controlling fiduciary power’ (2009) 68(2) *Cambridge Law Journal* 293, 309.
[58] [2020] EWHC 1674 (Ch).
[59] [2016] Bus LR 555.
[60] [2016] Bus LR 555, para [112].
[61] *Gant v* Ralls [2016] Bus LR 555, para [245].
[62] D. McKenzie, ‘Wrongful trading - a paper tiger?’ (1995) *The Juridical Review* 519, at 528.

not provide directors with the option to make reckless decisions when the company is in financial distress. An argument by directors that they succeeded in reducing the net deficiency of the company as regards to its general body of creditors may not result in an outright defence under s.214(3), since the directors must prove their defence that they took every step,[63] and this according to s.214(4) is both a subjective and objective test. It is important that reference is made to the manner in which the director chose to continue to trade, the impact that this had on the body of creditors, and whether it was reasonable to act in such a way when the COVID-19 related issues are considered. In contrast it is imperative to note that the general director duties such as duties to creditors, and the existing laws relating to fraudulent trading remain in place since there is no defence to acts of fraud against creditors, or generally speaking.[64]

In relation to misfeasance and breach of duties under s.212 of the Insolvency Act 1986, these have not been altered or suspended. To that end, "[any] person who in the affairs of the company exercises a supervisory control which reflects the general policy of the company for the time being or which is related to the general administration of the company is in the sphere of management".[65] This section can therefore be applied to a director of a company and it may require that they make a contribution to the company where in the course of a winding up there has been a misapplication of company money or other property of the company, misfeasance or breach of any fiduciary or other duty. The broadness of 'other duty' would encompass the duty of care, meaning that this provision includes claims based on negligence,[66] and it could also be triggered where a director breaches his or her directors' duties under the Companies Act 2006. While the director in question could request a contribution from insolvency practitioners based on the advice received that they could continue to trade before the company went into liquidation, in *Re International Championship Management Ltd* [67] it was illustrated that directors cannot readily relinquish their responsibility; although to continue to trade on professional advice has been used as a basis for escaping liability under s.212 of the Insolvency Act 1986.[68] Should this fail, in exceptional circumstances under s.1157 of the Companies Act 2006 the court can relieve the director, either wholly or partly, from liability if it can be established that he had acted honestly and reasonably and ought, in the circumstances, to be excused. But note that the Court of Appeal have made it clear in *Guinness Plc v Saunders*, that a director cannot be relieved of any liability on the grounds of acting honestly and reasonably in all the circumstances where the director has received the benefit of a breach of duty unless properly authorised to do so.[69] In these circumstances where the company has become insolvent, there is a subjective element to the test but that is only in cases where there is evidence of actual consideration by the particular director at the particular time

[63] See *Re Idessa (UK) Ltd (in liquidation)* [2012] 1 B.C.L.C. 80; [2011] EWHC 804 (Ch), para [28].
[64] Section 12 of the Corporate Insolvency and Corporate Governance Act 2020.
[65] *Re a Company (No.00996 of 1979)* [1980] Ch. 138, at 144
[66] *Re D'Jan of London Ltd* [1993] BCC. 646.
[67] *Re International Championship Management Ltd* [2006] EWHC 768 (Ch).
[68] *Re Continental Assurance Co of London plc (No.4)* [2007] 2 BCLC 287
[69] [1990] 2 AC 663, at 689G-692G.

that the payments were made. It remains the directors' obligation to persuade the courts from contemporaneous documents that the decisions that were taken fulfil this requirement. If the evidence is insufficient due a failure on the part of the director to produce accounting information up to the appropriate standard, it would be difficult to establish how that director can determine he acted reasonably. The cases make it clear that it is not the director that gets the benefit of the doubt arising from such deficiencies.[70] Lastly, s.175 provides that a director of a company "must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company".[71] Section 175(3) expressly provides that the section does not apply to a conflict of interest arising in relation to a transaction with the company.

Collectively, these duties may appear discernible, yet the flexibility to which they have been applied has led to several differing positions to emerge on the scope of the duties owed by a director a company. The application of these duties is expected to become more complex as a result of COVID-19 related factors. To this end there are several key issues to consider as highlighted in *Re System Building Group Limited (In Liquidation)*. First, the Companies Act 2006 is precise and always expressly states when given provisions were not to apply in an administration, compulsory liquidation, or CVL. In regard to the general director duties, to date there are no application restrictions in place; they remain relevant and applicable to all directors, yet inconsistencies have emerged since *Re System Building Group Limited (In Liquidation)* did not address the lack of case law that discusses directors' duties surviving compulsory liquidation. Since directors in both compulsory and voluntary liquidations tend to cease to be able to exercise their powers a distinction between the two appears to be superficial. Second, it was clear from ss.170 to 177 that the general duties of a director extended beyond their exercise of any given power as director. For example, ss.175, 176 and 170(2) were not dependent on the exercise of a given power *qua* director. Furthermore, In *Bhullar v Bhullar* [2003] BCC 711, Jonathan Parker J. considered the scope of s.175:[72]

> … The relevant rule, which Lord Cranworth LC in *Aberdeen Railway Co. v. Blaikie* described as being 'of universal application', and which Lord Herschell in *Bray v Ford* [1896] AC 44 (at [52]) described as 'inflexible', is that (to use Lord Cranworth's formulation) no fiduciary 'shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect'.

The approach taken to the duties is therefore not negotiable nor conditional since they are integral to the expected behaviour of directors. A duty such as not to profit from their position of trust, even if that profit could not have been made by their principal promotes

[70] *Wow Internet v Qasim Majid* [2020] EWHC 2890 (Ch), para [77].
[71] It is not necessary for a director to be relieved of liability simply because they have not personally obtained a profit as a result of the breach of duty. These fiduciary duties are stringent, see *Re Annacott Holdings Limited* [2013] BCC 98, para [23].
[72] *Bhullar v Bhullar* [2003] BCC 711, para [27].

integrity, trust and professionalism.[73]. Third, while some of the directors' duties in the Companies Act 2006 did not necessarily make sense when applied in an insolvency context, director's duties, as set out in ss.171 to 177, were based on underlying common law rules and equitable principles, which were of sufficient flexibility to extend beyond a company's entry into a formal insolvency process. This can be seen in both the fiduciary duty of loyalty, and in cases that concern conflicts of interest.[74] Fourth, s.172(3) expressly preserved a director's duties in certain circumstances "to .... act in the interests of creditors of the company".[75]

To that end, obligations are imposed on directors to consider creditor interests post insolvency, and these duties did not cease on a company's entry into a formal insolvency process but rather it becomes more critical to observe. The fifth point to note is contained in paras.61 and 64 of Schedule B1 to the Insolvency Act 1986 which made it clear that a company's entry into administration or voluntary liquidation did not result in the removal of a director from office, rather no officer of the company may exercise management power, meaning 'a power which could be exercised so as to interfere with the exercise of the administrator's powers', without the consent of the administrator.[76] While there is limited caselaw on this point, it would be clearly wrong to suggest that none existed.[77] As such the premise that the general duties of a director cease to exist on a company's entry into administration or creditors' voluntary liquidation, or their duties only apply to different parts of the company or its assets on the basis that some may be subject to administration,[78] is unfounded.[79] This position reflects that, for most of the part, licensed insolvency practitioners in this country are highly effective guardians of the assets of those companies in respect of which they are appointed.[80] In regard to 'guardianship' ICC Barber in *Re System Building Services Group Limited (In Liquidation)* stated that:[81]

> the law expects, in an insolvency situation, for more than one actor to play their part. And the directors have an important part to play', their fiduciary duties being 'an important part of the protection' afforded to the company and its creditors under English law.

Yet at the point in which an administrator is appointed, how are the actions of the directors and those of the administrator properly distinguished when the administrators are responsible for the management of the company concerned? This matter was explored recently in *Re ASA Resource Group Plc (In Administration);* Dearing v Skelton [2020] EWHC 1370 (Ch) where it was stated that the statutory scheme was plain: the administrators were responsible for the management of the company concerned, while the directors remained

[73] *Keech v. Sandford (1726) Sel Cas 61* (cited recently by the Supreme Court in *FHR European Ventures LLP v. Cedar Capital Partners LLC [2015]* AC 150 at [8])
[74] See *Cook v Deeks* [1916] 1 AC 554 and *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443
[75] See *BTI 2014 LLC v Sequana SA* [2019] BCC 631, at [137]-[180], citing *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250.
[76] *Re System Building Services Group Limited (In Liquidation)*, paras [38-39, 48-56]; *Re ASA Resource Group Plc* [2020] EWHC 1370 (Ch), para [25].
[77] For example, *McTear v Engelhard & Ors* [2014] EWHC 1056.
[78] See *Re ASA Resource Group Plc* [2020] EWHC 1370 (Ch) para [26].
[79] *Berg Sons & Co Ltd v Adams* [1992] BCC 661, at 679.
[80] *Re System Building Services Group Limited (In Liquidation)*, para [58].
[81] *Re System Building Services Group Limited (In Liquidation)*, para [59].

in office: para.59 of Schedule B1 of the Insolvency Act 1986. The administrators in this case should manage the company for the purposes of the administration and, at the second stage of the administration, in accordance with the approved proposals. The administrators could decide (give consent) at any stage to involve a director and permit that director to exercise management powers: para.64 of Schedule B1 of the Insolvency Act 1986.[82] The possibilities as to when such an occurrence could arise were plentiful and dependent on the circumstances in each individual case. At one end of the spectrum there were cases where to best achieve the purpose of the administration, directors would be empowered to manage the day-to-day running of the business subject to the administrators' supervision. This could be due to the reliance on their expertise and reliability and/or because it reduced the cost and expenses of the administration which might be unnecessary and/or detrimental to the purpose. Such an approach had been mooted as a potential route for companies suffering the financial consequences of the coronavirus pandemic.[83] The extent of the supervision would depend on the circumstances and the administrators' assessment of the need for supervision. At the other end of the spectrum were cases where part of the business remained operational, but it was not needed for the purpose of the administration. The administrators in this case might wish to leave that part of the business to the management of the directors' subject to supervision provided it did not adversely affect the purposes of the administration or fail to be in accordance with the proposals.[84]

The position of a director in the absence of consent is that they may not exercise a management power so as to interfere with the exercise of the administrator's powers. Bearing in mind the management of the company can often rely on the knowledge and skills of the directors who are displaced by the administrators for the purpose of administration, that is an extremely wide prohibition. Although the statutory and common law duties of directors continue,[85] the application of those duties will be restricted in practice by the statutory prohibition to the extent that there is compliance. This can be seen in *Closegate Developments (Durham) Ltd and another v Mclean and others,* where Mr Richard Snowden Q.C. sitting as a deputy High Court Judge, as he then was, decided that "the restriction on the exercise of management powers in para.64 of Schedule B1 of the Insolvency Act 1986 was primarily directed at powers which if exercised would impede the exercise of similar powers by the administrators".[86] He decided that directors had power to cause the company to challenge the validity of an administrator's appointment. Mr Justice Hildyard in *Re Lehman Brothers Europe Ltd,* explained that this was a power *"*inherent in the status of the company as a company in administration" not a power needed to be used to manage in accordance with the approved proposals or to give effect to the purposes of the administration.[87] In *Re Stephen Petitioner* Lord Glennie considered the restrictions associated with paragraph 64 in detail, and he concluded that:[88]

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[82] See also, *Re ASA Resource Group Plc* [2020] EWHC 1370 (Ch), para [32].
[83] *Re ASA Resource Group Plc* [2020] EWHC 1370 (Ch), para [30].
[84] *Re ASA Resource Group Plc* [2020] EWHC 1370 (Ch), paras [26, 30-31]).
[85] See *Re System Building Group Limited (In Liquidation)* [2020] EWHC 54 (Ch).
[86] [2013] EWHC 3237 (Ch), at 405.
[87] [2017] EWHC 2031 (Ch), para [65].
[88] [2012] BCC 537, para [4].

> What is prohibited is the exercise of a power which, reading short, interferes with the exercise of the administrators' powers. But an action which calls into question whether the administrators were validly appointed, and therefore whether they had any powers to exercise, is, to my mind, plainly not caught by his prohibition.

The scope of directors' duties can therefore be broadly construed to the extent it does not interfere with the role and decisions made by the administrator or liquidator. To that end, this position in *Re ASA Resource Group Plc* was made clear in that relief would not be granted if it was:[89]

> reasonable for the company to be placed into a position from which directors could resume control of management when the administration ceased. After all, the purpose of the administration was to rescue the company as a going concern.

On that basis directors of an insolvent company should be under no illusion that their actions would not be beyond reproach should the company become insolvent during COVID-19. However, while exceptions are unlikely to be viewed favourably an issue that is likely to emerge is the point in which the enhanced duties to creditors occur; in other words, when did the company become insolvent.

Directors 'enhanced' duties to creditors in a pandemic

While the *West Mercia* rule is clear on directors enhanced duties to creditors at the point of insolvency, what is unclear is whether the rule can be applied earlier.[90] In *Bilta v* Nazir, the rule was discussed in obiter as applying when a company was bordering on insolvency.[91] In other cases the test has varied from "on the verge of insolvency and it is the creditors' money that is at risk",[92] and where an action by a director would put at "real (as opposed to remote) risk" creditors' prospects of being paid.[93] Some clarity on this matter emerged in the recent case of *LLC v Sequana*[94] where the application of the rule in *West Mercia* was disputed; the counsel for the directors had argued it would only apply where the company was "very close" to insolvency, while the claimants thought it was "enough if there is a real, opposed to a remote, risk of insolvency".[95] The Court of Appeal dismissed the appeal and concurred with the earlier decision of 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 either on the verge of insolvency or likely to become insolvent".[96] The authorities did not provide support for it, and the decision if left unchanged had the undesired potential to lower the threshold

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[89] [2020] EWHC 1370 (Ch), at [35].
[90] A Keay, 'Formulating a Framework for Directors' Duties to Creditors: An Entity Maximisation Approach' (2005) 64(3) *C.L.J.* 614; A Keay, 'Directors' duties and creditors' interests' (2014) 130 *L.Q.R*. 443.
[91] *Bilta v Nazir* [2016] AC 1, para [123].
[92] *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 248 (Ch); [2003] BCC 885, para [74].
[93] *Re HLC Environment Projects Ltd, Hellard v Carvalho* [2014] BCC 337, para [89].
[94] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112; for an in-dept discussion on the treatment of directors in insolvent companies, see K Van Zwieten, 'Disciplining the directors of insolvent companies' (2020) 33(1) *Insolv. Int.* 2-10.
[95] *BTI 2014 LLC v Sequana SA* [2017] Bus LR 82, para [464].
[96] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, para [214]. This part of the judgment, inter alia, is on appeal and is due to be heard by the Supreme Court in May 2021.

and create an outcome that would "unduly chill entrepreneurial risk-taking by honest directors".[97] While the Court of Appeal did not consider it would be appropriate to introduce a test, the authorities did indicate that the duty may be triggered when a company's circumstances fell short of actual, established insolvency. While generally speaking English caselaw indicates that the test to be applied is if at the relevant time it appears the company was or is likely to become insolvent,[98] and directors knew or ought to have known that, there have been cases that have swayed away from this premise.[99] The rationale to consider gradual descent into insolvency, rather than sudden occurrence is not inconsistent to the state of near-insolvency; instead this approach merely reflects the reality of insolvency and the difficulty to pinpoint the exact trigger moment.[100] Since the preferred formulation is not necessarily concerned with when the test should be engaged, the focus requires creditor interests to be treated as "paramount"; even more so when the company is actually insolvent.[101] To this end, the shift in focus entirely depends on whether the company can pay its creditors in full as they fall due, and this may lead insolvency to be determined on a factual basis.[102] not necessary the exact point in which insolvency occurred.

Applied to situations arising or associated with COVID-19 there are likely to be multiple occasions at which creditors were at risk of not being paid by a company, whether in full or partially, even in cases where the company was not actually insolvent. An extension of the "real risk" approach would leave honest directors in difficult situations that could deter them from taking the necessary steps to enhance the value of the company. Yet various measures have been introduced by the UK government,[103] specifically CIGA 2020, which provided for the temporary exclusion for small suppliers from the provisions of s233B IA 1986 (Protection of supplies of goods and services);[104] the temporary prohibitions on winding up petitions based on statutory demands; and placed restrictions on winding up petitions and orders.[105] While these temporary debtor-friendly changes will alleviate some of risks, concerns remain to the behaviour of some directors towards creditors in this period, and the extent of insolvencies that could occur when the restrictions are lifted.[106] Further, to establish whether a company is likely to become insolvent, or is more probable than not to become insolvent when the CIGA measures were suspended poses an

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[97] K Van Zwieten, 'Disciplining the directors of insolvent companies' (2020) 33(1) *Insolv. Int.* 6.
[98] The term "likely" in this context, meant probable, see *Bilta (UK) Ltd (In Liquidation) v Nazir* [2013] EWCA Civ 968, para [22].
[99] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, para [195].
[100] See, *Burden Holdings (UK) Ltd v Fielding* [2016] EWCA Civ 557; *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, para [218].
[101] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, para [220].
[102] Efforts to restrict the duty-shifting rule to factual insolvency is unattractive, see K Van Zwieten, 'Disciplining the directors of insolvent companies' (2020) 33(1) *Insolv. Int.* 7.
[103] See generally, Coronavirus Act 2020.
[104] Inserted by s14 CIGA, which was extended to 30 March 2021.
[105] Set out in Sched 10 to CIGA, which was extended to 31 December 2020.
[106] For example, The Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) Regulations 2020 (the Extension Regulations). A useful summary of the changes can be read here*:* L. Conway*,* 'Coronavirus: changes to insolvency rules to help businesses' (House of Commons Library, 31 March 2020), *Briefing Paper No.8877*, available at <https://commonslibrary.parliament.uk/research-briefings/cbp-8877/> [Accessed 11 November 2020].

interesting dilemma. It is quite possible that with a further extension of the CIGA measures a near insolvent company could turn around its business and avoid insolvency altogether. Such an approach accepts the fickle nature of any attempt to pinpoint insolvency, but directors are under an obligation to identify the point when they knew or ought to have known that insolvency is likely to occur. While the position is perhaps more open to interpretation during the COVID-19 window, the directors must recognise that any successful action against them for personal liability and wrongful trading will depend on whether their actions, based on the information available at the time, can be justified. It is therefore likely to be prudent for directors to consider the interests of creditors as a class throughout this insolvency twilight period knowing the consequences if they fail to do so.[107] It can be inferred from this that paying one creditor and not all of the creditors in the class, the director's action offend the *pari passu* principle, unless the director was, in doing so, acting in the interests of the creditors as a whole.[108] The extent to which the creditor interests, and intra-creditor conflicts,[109] should be considered would depend on the circumstances of the case, with it also important to note that a creditor focus where the company is not yet insolvent could alienate and deter finance options from the shareholders.

The rescue of insolvent companies once the temporary CIGA suspensions are lifted will be placed under intense public and political scrutiny. While the debtor-friendly measures are designed to alleviate the burden on businesses during COVID-19 and could again be extended to allow companies to focus their efforts on continuing to operate, to survive attention is likely to shift to the new permanent restructuring procedures that leaves current directors in office with an opportunity to restructure the business with the benefit of a wide ranging moratoria and stays of creditor and counterparty rights.[110] Such measures are designed to offer the means for the continuity of distressed yet economically viable companies,[111] however the diversity in which corporate rescue may occur varies considerably since its different frameworks, guidelines, and threads renders rescue as a highly complex and discretionary process that can be broadly conceived.[112]

Conclusion

The two recent cases of *Re System Building* and *Sequana* have provided some useful guidance on director duties. It is clear from *Re System Building* that insolvency does not

[107] *GHLM Trading Ltd v Maroo* [2012] 2 BCLA 369, para [168].
[108] A Keay, 'Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests' (2020) 136 *L.Q.R.* 52, 59.
[109] See K Van Zwieten, 'Director liability in insolvency and its vicinity' (2018) 38(2) *Oxford Journal of Legal Studies* 382.
[110] See Part A1 to CIGA 2020.
[111] See generally, G McCormack, 'Apples and oranges: Corporate rescue and functional convergence in the US and UK', 18(2) *International Insolvency* Review (2009) 109-134; V Finch, Corporate Rescue: A Game of Three Halves' (2012) 32(2) *Legal Studies* 302-324; B Adebola, 'An invitation to encourage due consideration for the survivability of rescued businesses in the business rescue system of England and Wales', 26(2) *International Insolvency Review* (2017) 129-152. For an in-depth discussion on discretion in insolvency, see J Wood, 'Insolvency office holder discretion and judicial intervention in commercial decisions', 6 *Journal of Business Law* (2020) 451-475.
[112] D Burdette and P Omar, 'Why Rescue? A Critical Analysis of the Current Approach to Corporate Rescue', in J Adriaanse and JP van der Rest (eds) *Turnaround Management and Bankruptcy* (Routledge, 2017) 211-237.

alter directors’ duties, but rather it enhances and refocuses the obligations that already exist. To that end, directors post insolvency are expected to not only adhere to their general director duties, but they are obliged and encouraged to pay even closer attention to them.

The point in which directors should consider the creditors’ interests was examined in *Sequana*. Two alternative trigger points were proposed, with, “a real as opposed to remote risk of insolvency” pitted against, “insolvency, or very close to insolvency”. Based on the caselaw there were no English authorities that provided any support to an alternative view that nothing short of actual insolvency would do. To accept a real, as opposed to a remote risk of insolvency, the test would be problematic since this could arise even though a company is not insolvent and may very well not become insolvent. The threshold for this test would therefore be low compared to whether a company is likely to become insolvent. While *Sequana* is currently on appeal, it is likely that the Supreme Court will maintain the actual insolvency test in line with the caselaw and this will have several important implications.

First, an alternative approach to actual insolvency would hinder appropriate risk taking by directors, and it would likely encourage directors not to implement the required measures needed due to fear of being held accountable. Second, if restrictions on directors’ conduct was intended where a company is anything other than insolvent or near insolvency, Parliament would have done so through legislation. Third, when efforts are made to establish the test, the preferred formulation is not necessarily concerned with when the test should be engaged, but the point when creditor interest are to be treated as ‘paramount’. This would indicate that the test can be identified at the point when the company cannot pay its creditors in full as they fall due. As such, insolvency in this case would be determined on a factual basis and would be difficult to dispute.

Applied to a post COVID-19 environment, much will depend on the duration in which CIGA 2020 continues to suspend various insolvency provisions. While the suspension of section 214 IA 1986 does not mean that directors are completely beyond reproach, since the temporary suspension applies only to a limited timeframe, directors would still be expected to identify the point when they knew or ought to have known that insolvency was likely to occur. This could be problematic if the threats are perceived to be COVID related and as such short-term. Such conclusions could lead directors to presume that the threat of insolvency is remote, and the economic downturn is merely temporary.

While a director could take an optimistic view of the company’s finances since the point of insolvency is more open to interpretation during the COVID-19 window, the directors must recognise that any successful action against them for personal liability and wrongful trading will depend on whether their actions, based on the information available at the time, can be justified. Based on the critique that the two cases have produced on the directors’ general duties and what conduct is expected, it would be hard to see directors being successful in this pursuit. It is therefore likely to be prudent for directors to consider the interests of creditors as a class throughout this insolvency twilight period knowing the consequences if they fail to do so.