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ZONE OF INSOLVENCY – DIRECTORS IN THE FIRING LINE

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2018 saw a number of high-profile insolvencies around the world. That trend is expected to continue this year with many sectors facing an extremely challenging trading environment and the UK further hindered by continuing uncertainty around Brexit. It means that at no time in recent history has the scrutiny placed on directors' conduct in the build up to a collapse been so intense and the importance of understanding and managing a director's duties in times of financial distress been so fundamental. In the latest submission for Compliance Matters by experts in Guernsey's legal sector, Carey Olsen Partner David Jones and Associate Tim Molton examine those duties in greater detail, particularly in relation to Guernsey's own company law.

Focus on decision making

Directors owe duties to the company they serve, and ordinarily exercise those duties with reference to the interests of the company's members as a whole.

When the company is "in the zone of insolvency", the actions (or inaction) of directors have potential to prejudice the company's creditors. In those circumstances, directors must discharge their duties predominantly with the interests of creditors in mind.

The scrutiny applied to that shift in focus becomes sharpest when a company is placed into liquidation pursuant to the Companies (Guernsey) Law, 2008, as amended (the Companies Law). In certain circumstances, a liquidator may seek orders that an officer account for (or contribute towards) any losses suffered by the company as a consequence of the director's conduct either prior to, or after the company became insolvent.[1]

The basics

Directors owe both fiduciary and non-fiduciary duties to the company. The fiduciary duties include to:

1. act bona fide in the best interests of the company;
2. act for proper purposes/not to act for improper or collateral purposes;
3. exercise independent judgement; and
4. avoid conflicts of interest.

Whether a director has fulfilled his fiduciary duties to the company will be tested (predominantly) subjectively, with the focus on the director's state of mind.

A directors' duty of skill and care, however (a non-fiduciary duty), is measured both objectively and subjectively[2]. In determining the scope of the duty, a court will consider:

1. the director's actual knowledge, skill and experience (subjective test); and
2. the knowledge, skill and experience that may be expected of someone fulfilling that director's role (objective test).

A director's duty of care and skill cannot be diminished on the basis of the director's actual knowledge and experience. The bar can only be raised where a director has such experience and skill that one would have expected him/her to have acted differently in the circumstances.

What does solvent really mean?

In Guernsey, section 527(1) of the of the Companies Law provides that a company will satisfy the solvency test if inter alia:

1. it is able to pay its debts as they become due (the Cash Flow Test); and
2. the value of the company's assets is greater than the value of its liabilities (the Balance Sheet Test).

The solvency test is cumulative; hence, a company must pass both the Cash Flow Test and the Balance Sheet Test.

Any analysis of balance sheet solvency must include contingent and prospective liabilities. Whilst the law in that area is nuanced and fact-specific, the cumulative nature of the test may render many companies technically insolvent. As a result, a board's decision-making at that time may be scrutinised from the perspective of damage caused to creditors.

POTENTIAL ACTIONS

Preferences

A liquidator may apply to the court for an order to set aside a transaction if it was entered into at a time when the company was insolvent or it becomes insolvent as a result of the transaction. Any payment made within six months (or two years in the case of a "connected party") immediately preceding the application for a compulsory winding up (or a resolution for voluntary winding up) is vulnerable to be set aside.

A company is deemed to have given a preference to a person where:

1. "that person is one of the company’s creditors or is a surety or guarantor for any of the company’s debts or other liabilities"; and
2. the company, "does anything, or permits anything to be done, which improves that person’s position in the company’s liquidation".

It is also important to consider whether the company's directors (as decision makers) were influenced by the necessary "desire" to prefer. Establishing such desire will involve demonstrating that the company was influenced by an intention to put one or more creditors in a better position than the general body of creditors.

Any transaction with a "connected party" during the reference period which would constitute a preference is presumed to be outside of the ordinary course of business and made with the requisite desire to prefer.

If a preference has been given, the court has wide-ranging powers to restore the company to the position it would have been absent the preference, including making directors personally liable.

Transactions at an undervalue

While there is no codified law relating to transactions at an undervalue (as in the UK), similar actions may be available to liquidators under Guernsey's customary law.

One possibility is to establish that the recipient of the company’s assets had knowledge of the directors' breach of fiduciary duties (by selling assets at an undervalue). It could then be claimed that retention of the assets by the recipient (as constructive trustee) ought to be impermissible.

Alternatively, a liquidator may bring a customary law Pauline action[3], which is concerned with setting aside a transaction undertaken to defraud creditors where the debtor was insolvent at the time or as a result of the transaction.

The rationale of the Actio Pauliana is that - "... if a person has alienated his property in fraud of creditors who have been put in possession ... they are allowed to bring an action cancelling the alienation, that is alleging that the property has not been alienated and therefore remains an item in the debtor's estate.[4]"

The critical elements would be that:

1. the debtor must have been insolvent on a balance sheet basis at the time of the transaction; and
2. the debtor carried out the transaction with the intention of defrauding creditors.

A Pauline action has been held in Jersey to be an action personnelle mobilière, for which the limitation period for bringing a claim in Guernsey is six years. There have been two Guernsey cases decided on principles akin to the Pauline action[5], the remedy for which is restitutionary in nature (meaning that, if the action is successfully established, the transfer of assets is set aside and the assets become available to satisfy the creditor's claim).

Misfeasance / Breach of Fiduciary Duty

Where in the course of a company's winding up it appears that any director (a) has appropriated or misapplied any of the company's assets, (b) has become personally liable for any of the company's debts or liabilities, or (c) has otherwise been guilty of any misfeasance or breach of fiduciary duty, the liquidator (or any creditor or member of the company) may apply to the Court for an order against the director personally. As noted above, the test for a breach of fiduciary duty is a subjective one[6].

If a claimant is successful in proving misfeasance or a breach of duty, the court may, inter alia, order the delinquent director to repay, restore or account for such money or property; or contribute sums towards the company’s assets, whether by way of indemnity, compensation or otherwise[7].

Wrongful trading

Where a company has gone into insolvent liquidation at some time before the commencement of a winding up, and a director knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation, the liquidator (or any creditor or member of the company) may apply to the Court for a declaration that the director shall be liable to contribute to the company's assets.

It will, however, be a defence for a director to demonstrate that he/she took every reasonable step, at the appropriate time, to minimise the loss to creditors.

In practical terms, wrongful trading is often the greatest fear for directors in times of financial distress. A company may, in the course of its life, find that it fails one or both limbs of the solvency test. That failure should not, however, be automatic trigger for an insolvency process and there are circumstances where the reasonable belief and prospect of an improvement, restructuring or turnaround dictate that trading should continue.

The sanction against wrongful trading is not designed to punish the honest director who takes a reasonable decision, but rather to punish those that carry on with no reasonable expectation of improvement and, in doing so, diminish the net assets of the company in an insolvency.

Fraudulent trading

Pursuant to section 432 of the Companies Law, if any business of a company is carried on with intent to defraud creditors, or for any fraudulent purpose, every person who is knowingly a party to such business is guilty of an offence.

If in the course of a winding up it appears that any business has been carried on with intent to defraud creditors, the liquidator may apply to the Court for an order that the director(s) contribute to the company's assets. The director may also be criminally liable. The phrases "with intent to defraud creditors" and "for any fraudulent purpose" require a finding of actual dishonesty. If a company continues to carry on business and to incur debts at a time when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment on those debts, such dishonesty can be inferred.

Relief from sanction

Pursuant to section 522 of the Companies Law, the Court may relieve a director of liability if, in proceedings for negligence, default, breach of duty or breach of trust, it appears that the director has acted honestly and reasonably and that, having regard to the circumstances, he ought fairly to be excused from liability.

It should be noted that any proposal that purports to exempt a director (to any extent) from liability incurred in connection with any negligence, default, breach of duty or breach of trust may be void.

Disqualification

The Court may make a disqualification order[8] where it considers that, by reason of a person's conduct, that person is unfit to be concerned in the management of a company. Pursuant to section 428(3) of the Companies Law, the Court may have regard to, inter alia, the following:

1. whether the director has been held liable to make contributions to a company's assets under section 433, 434 or 435;
2. the director's conduct in connection with any company that has gone into insolvent liquidation; and/or
3. any misfeasance or breach of any fiduciary or other duty by him in relation to a company.

The Court can make a disqualification order of its own motion or upon an application brought by, inter alia, the GFSC, the Registrar, any company of which the person is or has been a director or has participated in its management, any liquidator, administrator, member or creditor of such a company or any other interested party with the leave of the Court.

Conclusion

Company officers should perpetually monitor the financial state of the company, but it is vital that they understand the nature of their duties and how to discharge them when the company appears to be in the zone of insolvency. How officers conduct themselves in such circumstances may have significant implications not just for the company, its members and creditors, but also for the individual officers, whose conduct may be called into question and which could lead to personally liability if they are found to have breached their duties.

Carey Olsen Restructuring & Insolvency

Carey Olsen has a dedicated restructuring and insolvency practice in Guernsey. The team has broad experience advising on the full range of restructuring, recovery and insolvency matters, and has acted in respect of many of the largest and most complex local and cross-border insolvency appointments affecting the Island.

[1] For example, a decision is awaited from Guernsey's Court of Appeal in relation to the circa US$2 billion

claims against the former directors of Carlyle Capital Corporation Limited by its liquidators relating to their conduct in the build up to its collapse in the early stages of the global financial crisis of 2007/2008.

[2] This is also the position in the UK as codified under section 214(4) of the Insolvency Act 1986

[3] The availability of this action was recognised in Guernsey by Lieutenant Bailiff Southwell Q.C. in Flightlease Holdings (Guernsey) Limited v. International Lease Finance Corporation [2004].

[4] Jersey & Guernsey Law Review – February 2008, ' Restitutionary Weapons in the Fight Against Fraud', para 21.

[5] Morgan v Donaldson (18 July 1985) and Le Ray v Martel (7 July 1747)

[6] In the case of Carlyle Capital Corporation Limited (in Liquidation) and others v. Conway and others[6], HH Marshall LB, held that: "There is no fiduciary duty to make an objectively "right" decision"; and "… a decision (whether right or wrong) reached by directors cannot be a breach of fiduciary duty if they have honestly made it in what they consider to be the interests of the company…" [at para 379].

[7] section 422(3) of the Companies Law.

[8] A disqualification order may prohibit a person from, inter alia, (a) being a director, secretary or other officer of any company, (b) being a shadow director of any company, or (c) participating in, or being in any way concerned in, the management, formation or promotion of any company.

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