

CONTEMPORARY COMMERCIAL LAW

informa law
from Routledge

COMPANY DIRECTORS' LIABILITY AND CREDITOR PROTECTION

ANDREW KEAY



Designed cover image: Getty

First published 2023
by Informa Law from Routledge
4 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Informa Law from Routledge
605 Third Avenue, New York, NY 10158

Informa Law from Routledge is an imprint of the Taylor & Francis Group, an informa

© 2023 Andrew Keay

The right of Andrew Keay to be identified as author of this work has been asserted in accordance with sections 77 and 78 of the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this book may be reprinted or reproduced or utilised in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

Trademark notice: Product or corporate names may be trademarks or registered trademarks and are used only for identification and explanation without intent to infringe.

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library

ISBN: 978-0-367-21051-9 (hbk)
ISBN: 978-1-032-51511-3 (pbk)
ISBN: 978-0-429-26623-2 (ebk)

DOI: 10.4324/9780429266232

Typeset in Times New Roman
by Apex CoVantage, LLC

CONTENTS

<i>Preface</i>	xi
<i>Table of cases</i>	xiii
<i>Table of legislation</i>	xxvii
PART A INTRODUCTION	
CHAPTER 1 BACKGROUND	3
Unpaid Debts and Creditors	3
Directors	3
The Format, Approach and Purpose of the Book	5
CHAPTER 2 DIRECTORS	7
Introduction	7
General	7
De Jure Directors	8
De Facto Directors	8
Shadow Directors	11
Distinguishing Between De Facto and Shadow Directors	12
Executive and Non-Executive Directors	13
Responsibilities and Obligations	14
Conclusion	17
CHAPTER 3 CREDITORS	18
Introduction	18
Who Is a Creditor?	18
Contingent Debts	19
Prospective Debts	19
Future Debts	19
Kinds of Creditors	19
Consensual Creditors	20
Involuntary Creditors	23
Creditor Protection	23
Contractual Protection	23
Pre-Contract Checks	24

CONTENTS

Security
Monitoring
Imposing Higher Interests
Conclusion

CHAPTER 4 CLAIMANTS AND ACTIONS

Introduction
Claimants
Proceedings
Misfeasance
Conclusion

PART B FRAUDULENT TRADING

CHAPTER 5 BACKGROUND AND AIM

Introduction
Background
Aim
Conclusion

CHAPTER 6 FRAUDULENT TRADING: THE PROVISION AND ITS SCOPE

Introduction and Background
The Elements: An Introduction
The Applicant
Applications
Persons Who May Be Liable
Directors and Company Officers
Employees
Outsiders (Accessories)
Criminal Proceedings
Conditions for Liability
Party to the Carrying on of Business
Knowingly
What Constitutes Fraudulent Trading?
Loss
The Order
Relief From Liability
The Destination of Proceeds
Conclusion

CHAPTER 7 INTENT TO DEFRAUD AND FRAUDULENT PURPOSE

Introduction

CONTENTS

Intent to Defraud	70
Dishonesty	70
The Issues	72
What Actions Can Constitute Fraud?	83
‘Fraudulent Purpose’	84
Conclusion	85

PART C WRONGFUL TRADING

CHAPTER 8 WRONGFUL TRADING: BACKGROUND, AIMS AND RATIONALE

Introduction	89
Background	90
Aims	95
Rationale	96
Conclusion	98

CHAPTER 9 AN EXPOSITION OF THE WRONGFUL TRADING PROVISION AND ITS SCOPE

Introduction	99
The Applicant	99
Claims	100
The Elements Required for Liability	105
Insolvent Liquidation	105
Directors	106
Knowledge	108
No Reasonable Prospect of Avoiding Insolvent Liquidation	115
The Point of Liability	116
What Should Directors Be Doing?	123
Judicial Considerations	124
The Types of Companies Involved in Actions	129
Loss	130
The Order	136
Introduction	136
Judicial Discretion	137
Compensation in the Order	139
Payment of Existing Debts With New Money	140
Concurrent and Additional Liability	142
Division of Liability	143
Other Matters Contained in Orders	144
The Effects of an Order	145
Compensation Orders Under the Company Directors’ Disqualification Act 1986	148
The Public Factor	149
Conclusion	150

CONTENTS

CHAPTER 10 THE WRONGFUL TRADING DEFENCE

Introduction
The Substance of the Defence
What Constitutes 'Every Step'?

Introduction
Professional Advice
Resignation
Placing the Company Into a Formal Insolvency Regime
Cessation of Business
Miscellaneous Options
Inability to Take Steps to Minimise Losses
Conclusion

CHAPTER 11 RELIEF FROM LIABILITY

Introduction
Relief Under the Companies Act 2006?
Is Relief Under the Companies Act Necessary?
Conclusion

PART D THE OBLIGATION TO CONSIDER THE INTERESTS
OF CREDITORS

CHAPTER 12 THE DEVELOPMENT OF THE OBLIGATION

Introduction
The Evolution of the Obligation
The Genesis
The UK Developments of the Last Century: The Early Days
Judicial Opinion in the UK in the 1990s and Early 2000s
Section 172(3) of the Companies Act 2006: The Statutory Aid
Cases Post Companies Act 2006
The Supreme Court in *Sequana*
Conclusion

CHAPTER 13 THE NATURE OF AND RATIONALE FOR THE
OBLIGATION

Introduction
The Nature of the Obligation
The Foundation of the Obligation
The Traditional Foundation
The Disconnect?
The Case Law and Other Explanations
The Judicial Foundations
Conclusion

CHAPTER 14 WHEN DOES THE OBLIGATION ARISE?

Introduction

CONTENTS

Background	216
The Importance of the Trigger	218
Insolvency	219
The Obligation and Pre-Insolvency Circumstances	226
Context	226
The Judicial Formulations	228
The Supreme Court in <i>Sequana</i>	230
The Knowledge of the Directors	233
Reflections	234
Conclusion	236

CHAPTER 15 COMPLYING WITH THE OBLIGATION

Introduction	237
Context	238
The Content of the Duty	239
Insolvency	240
When Insolvent Liquidation or Administration Is Probable	242
Circumstances Short of Insolvency	243
Summary	245
The Nature of the Consideration to Be Given to Creditor Interests	245
Balancing	246
Paramourncy of Creditor Interests	250
Factors and Issues in Considering Creditor Interests	252
Creditors v Creditors	256
Conclusion	270

CHAPTER 16 COMMENCING PROCEEDINGS AND
DETERMINING LIABILITY

Introduction	271
Who Can Commence Proceedings?	271
Respondents to Proceedings	273
The Relationship to Wrongful Trading	275
Limitation of Actions	276
Disadvantages With Proceedings	279
Granting Judicial Relief	279
Security for Costs	279
Enforcement	281
Proceeds of Judgment	281
Determining Liability	281
Conclusion	284

CHAPTER 17 RELIEF FROM LIABILITY

Introduction	285
Ratification	285
Judicial Relief	286
Conclusion	288

PART E DIMINUTION OF COMPANY FUNDS
CHAPTER 18 UNLAWFUL DISTRIBUTIONS

- Introduction
- Starting Points
- Distributions and the Legislative Framework
 - Introduction
 - In General
 - Public Companies
 - Dividends
- Liability for Unlawful Distributions
 - Member Liability
 - Director Liability
 - Auditor Liability
- Relief From Liability
- Conclusion

Index

PREFACE

Companies are managed by directors who, as a result, are the ones who determine in what direction companies go and what they do. This means that they play very important roles and they need to discharge significant functions. As a consequence of this the law imposes many obligations on directors. Some of these are to protect the shareholders, and a number of these are designed to ensure that the directors act appropriately and do not engage in self-dealing. Besides these obligations, the law also provides that directors have obligations which are effectively constructed to protect creditors of the company, and it is with these obligations that the book is concerned. This book endeavours to focus on four primary obligations. These are the obligations not to engage in fraudulent trading, to avoid engaging in wrongful trading, to consider the interests of creditors during periods of a company's financial distress, and to refrain from making unlawful distributions from company funds. If these obligations did not exist, then directors could act in such a way that creditors could lose out when companies are unable to pay the debts which they owe. The obligations provide potentially important protections for creditors. Their breach, when a company falls into insolvent administration or liquidation, may well lead to an administrator or liquidator commencing proceedings against miscreant directors.

The obligations considered in the book have been the subject of a complex and detailed case law, and this is examined in this book along with the statutory provisions that establish the obligations of the directors. The book is an analytical exposition of the law as it has developed in relation to the obligations. It is divided into five parts to reflect the four obligations referred to in the previous paragraph together with an introductory part.

I would like to thank Informa plc, publisher of *Lloyds Maritime and Commercial Law Quarterly*, for allowing me to use parts of my article 'Financially Distressed Companies, Restructuring and Creditors: What is a Director to do?' [2019] *Lloyds Maritime and Commercial Law Quarterly* 297–317.

I thank Guy Loft and Amelia Bashford from Routledge for liaising with me and providing me with guidance during the writing and publishing processes. I would also like to thank Marie Roberts for managing the preparation of the book for publication.

I have stated the law as it was available to me as at 1 November 2022.

Andrew Keay

often do this informally, but this is generally not sustained and its effect is very problematic. Formal and substantial monitoring can be time-consuming and costly, and even then it might not be sufficient to keep the creditors informed.²⁴ The problem is that many creditors will not have the resources to carry out necessary monitoring. If a creditor decides that it will need to monitor a company, then it will have to build a cost factor into the price of the goods which it extends to the debtor, because obtaining information and monitoring the affairs of a company are costly undertakings,²⁵ particularly if professional advice is sought. This might make the price of the goods or services uncompetitive.

Imposing Higher Interests

3.37 If a creditor is concerned about the company as a credit risk, it may demand that the company pays a higher rate of interest on credit. While this might compensate a creditor, it does not protect the creditor in the event of the company failing and being unable to repay the debt owed.

Conclusion

3.38 'Creditors' is a very broad term and may include a wide range of persons giving some form of credit. The group may consist of lenders who have not granted security (fixed, floating or both) (chiefly, banks), those holding secured debt (holding publicly issued bonds or debentures), trade creditors, employees, those with tort claims, and it might, in some circumstances, include others such as those who have paid deposits for goods and/or services to be supplied in the future. This book will from time to time consider specific kinds of claims but generally when a reference is made to creditors the whole range of persons to whom that a company might have is in view.

CHAPTER 4

Claimants and Actions

Introduction

4.1 Thus far we have considered the parties who are the main focus of the book, namely directors and creditors. In this chapter we consider who may bring claims against directors where they have not acted properly and what kind of actions can be initiated. When dealing with each of the obligations which are discussed in this book in Parts B–E, more specific details will be provided in relation to who can bring proceedings and what types of proceedings might be instigated.

Claimants

4.2 Directors do not owe duties to creditors during the life of their company; duties are owed to the company.¹ Also, the responsibilities which directors have, and which are discussed in this book, are not ones that are specifically owed to the creditors. Creditors are not able to bring proceedings against directors if directors fail to meet the obligations that are analysed in this book.

4.3 Unlike in some countries, such as Australia, there is no corporate regulator in the UK which is empowered to take action against directors who fail to meet those responsibilities owed by directors and discussed in this book. It should be added that the Secretary of State for Business Energy and Industrial Strategy might, through the Insolvency Service, seek the disqualification of a director under the Company Directors' Disqualification Act 1985, for not complying with certain specified obligations.

4.4 Shareholders might seek to make claims against directors using the derivative action process found in the Companies Act 2006,² where directors have failed their responsibilities. Section 260(3)³ provides that a claim may be brought in relation to a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director.

¹ Companies Act 2006, s 170(1).

² Ibid, ss 260ff.

³ For England and Wales and Northern Ireland. Section 265(3) is the equivalent provision applying in Scotland.

²⁴ See the comments in Brian Cheffins, *Company Law: Theory, Structure and Critique* (Oxford: Oxford University Press, 1997), 524.

²⁵ R Posner, 'The Rights of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 508.

Shareholders bring an action on this basis on behalf of the company and the action granted by a court goes to the company. Shareholders are not going to be bringing a derivative action in relation to any of the responsibilities discussed in this book, as it is not going to benefit them unless they are also creditors of the company.

4.5 An action relating to a director's failure to meet the responsibilities discussed in this book will be brought by an administrator or liquidator who are not creditors of the company when a company enters either administration or liquidation. In fact, a director's responsibilities that are considered in the book, not to engage in fraudulent trading and wrongful trading can only be enforced, according to the Insolvency Act 1986 ('the Act') itself, by an administrator or liquidator. The actions considered in the book will only occur where a company has become insolvent and has entered administration or liquidation, although the actions brought may relate to a point of time when the company was not insolvent. For instance, the responsibility of a director to take into account the interests of creditors, and discussed in the book, can arise prior to the actual insolvency of the director's company.

Proceedings

4.6 The Act provides that an administrator, under s 246ZA, and a liquidator, under s 213 may bring an action against directors if they breach their obligations not to engage in fraudulent trading (discussed in Part B). Likewise, the administrator, under s 246ZB, and a liquidator, under s 214, may bring an action against directors if they breach their obligation not to engage in wrongful trading (discussed in Part C). Administrators and liquidators are not empowered to enforce breaches of the other responsibilities discussed in the book, but they can do so when they act on behalf of the company and bring proceedings in the name of the company.

4.7 Part D examines the duty of directors to take into account the interests of the creditors of their company in certain circumstances and if they fail to do so, an administrator or liquidator who will instigate proceedings against the directors once the company enters either administration or liquidation. If the directors do not enter administration or liquidation, it will usually mean that the company's affairs have been made good. If directors fail to meet their obligations to make distributions of company funds out of profits (discussed in Part E), only an administrator or liquidator that will initiate proceedings against the miscreant directors. These proceedings might be in lieu of or in addition to proceedings brought against any shareholders who received the distributions.

4.8 In any particular situation a liquidator or administrator may bring proceedings claiming alternative causes of action.

Misfeasance

4.9 With actions mentioned in 4.7, liquidators will usually include in their claims what is known as a misfeasance summons.⁴ Section 212 of the Act

⁴ For a broader discussion of misfeasance actions, see Andrew Keay, *McPherson and Keay's Law of Company Liquidation* (5th ed, Sweet and Maxwell, 2021), [16.005] – [16.028].

liquidator, amongst others, to institute this type of proceeding against directors where it is alleged that they have misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company which the liquidator is winding up. Breaches of the responsibilities considered in Parts D and E fall within s 212.

4.10 For a misfeasance action to succeed under s 212, it must be founded on some action in relation to which the company could have initiated proceedings prior to winding up, namely a breach of any fiduciary or other duty owed to the company;⁵ so, under s 212 an applicant must 'establish actionable wrongdoing by the respondent independently of s 212.'⁶

4.11 Section 212, in accordance with its legislative precursors, does not provide liquidators with a cause of action. As Lord Evershed MR observed,⁷ there is no such distinct wrongful act known to the law as misfeasance; it is merely procedural in effect.⁸ It provides a summary mode of bringing proceedings.⁹ A misfeasance action will usually plead that directors have breached one or more of their duties. Section 212 is designed to facilitate recovery of assets improperly dealt with, and to enable the liquidator to obtain compensation for misconduct which had caused loss to the company.¹⁰

4.12 There are a number of practical advantages to a liquidator in pursuing misfeasance proceedings under s 212, which the liquidator does in his or her own name, rather than taking proceedings in the normal manner under Part 7 of the Civil Procedure Rules ('CPR') and in the name of the company. First, unlike an insolvent company a liquidator is not susceptible to an application for security for costs, potentially a serious obstacle to the conduct of claims. Secondly, the procedure under Part 12 of the Insolvency 2016 Rules by which a misfeasance claim under s 212 is pursued, is generally quicker in terms of the listing of an initial return date at which directions are given and the cost of issuing proceedings is less than proceeding under Part 7 of the CPR.¹¹ Thirdly, and related to the first factor, an after the event costs insurer is, generally speaking, likely to consider a claim pursued by a liquidator to be a better commercial prospect than one pursued by an insolvent company in liquidation potentially susceptible to a security for costs order.

4.13 As intimated, the existence of s 212 does not displace the right of the company to bring action in the ordinary way, and it created no new rights or

⁵ For a recent instance of a misfeasance action, see *Re Simmons Box (Diamonds) Ltd* [2000] BCC 275, which involved directors failing to act carefully.

⁶ Fidelis Oditah, 'Misfeasance Proceedings Against Company Directors' [1992] LMCLQ 207, 208.

⁷ *Re B. Johnson & Co (Builders) Ltd* [1955] Ch 634, 648.

⁸ *Cavendish-Bentinck v Fern* (1887) 12 App Cas 652, 669; *City Equitable Fire Insurance Co, Re* [1925] Ch 407, 527; *Re B. Johnson & Co (Builders) Ltd* [1955] Ch 634, 647–648.

⁹ *Re Canadian Land Co: Coventry & Dixon's Case* (1880) 14 Ch D 660, 670.

¹⁰ *Re B. Johnson & Co. (Builders) Ltd* [1955] Ch 634.

¹¹ If a claim that would fall under s 212 if brought by a liquidator is assigned then the assignee is not able to bring proceedings under Part 12 of the Insolvency Act 1986 but has to proceed under Part 7 of the CPR: *Manoleta Partners Plc v Hayward and Barrett Holdings Ltd* [2021] EWHC 1481 (Ch), [51]–[52].

liabilities but was simply intended to provide a summary mode of enforcement of rights which, apart from the section, could have been enforced by the provisions which apply in winding up.¹³ As Lord Macnaghten in *Bentinck v Fenn*¹⁴ stated in relation to a precursor of s 212, it 'creates no new offence, and . . . it gives no new rights, but only provides a summary remedy in respect of rights which apart from that section might have been vindicated either at law or in equity.'

4.14 The process is not available in administration, even though s 212 of Sch B1 to the Insolvency Act 1986 does deal with misfeasance. This provision may only be used against administrators who have acted improperly.

Conclusion

4.15 The chapter has been concerned with examining who will be liable in proceedings to enforce wrongful actions engaged in by directors and on liquidators and administrators who are the persons who most often bring proceedings, and in fact they are the only people who can take action against directors for breaches as the law grants them that right. After considering the proceedings the chapter discussed in some depth the misfeasance that can be brought by liquidators, this being a frequent way that proceedings will proceed against directors.

PART B

FRAUDULENT TRADING

¹² Rights personal to a creditor or contributory in an individual capacity could not be enforced against a company in *Hill's Waterfall Estate Co* [1896] 1 Ch 947; B Parker and M Buckley, *Buckley on the Companies Act* (14th ed, Butterworths, 1981), 375-376.

¹³ *Home & Colonial Insurance Co, Re* [1930] 1 Ch 102, 132, per Maugham J. This case covers such as voidable preferences, dispositions after the commencement of winding up, etc.

¹⁴ (1887) 12 App Cas 652.

Background and Aim

Introduction

5.1 This chapter begins consideration of the legislation and case law that has imposed certain responsibilities on company directors as far as creditors are concerned. Specifically, in this chapter we will examine the advent, development and *raison d'être* for the provision dealing with what is commonly known as 'fraudulent trading.' Following that, the chapter identifies the aim of the provision. The ensuing chapters discuss aspects of the fraudulent trading provision and its use by administrators and liquidators in bringing proceedings against directors.

Background

5.2 For many years company legislation has made it an offence to carry on the business of a company with intent to defraud creditors. Also, the legislation has provided that a civil remedy is available where such activity can be proved. The first provision that was enacted to deal with what has been loosely referred to as 'fraudulent trading' was s 75 of the Companies Act 1928. There had been dissatisfaction in the first quarter of the twentieth century at the ease with which the protection of limited liability could be abused by those who managed companies, and in 1926 the Greene Committee on Company Law Reform¹ had its attention directed particularly to the case, said to be encountered principally in private companies, 'where the person in control of the company holds a floating charge and, while knowing that the company is on the verge of liquidation, "fills up" his security by means of goods obtained on credit and then appoints a receiver.'² The Committee's recommendation, which with one small addition was originally embodied in s 75 of the Companies Act 1928, was that a new section should be inserted providing that where, in the course of winding up a company, it appeared that any business of the company had been carried on with intent to defraud creditors of the company, the court should have power, on application by the liquidator or any creditor or contributory, to

¹ Report of the Company Law Amendment Committee, Cmnd 2697, HMSO, London, 1926.

² Ibid, [61].

declare that the directors responsible should be subjected to unlimited liability in respect of the debts or other liabilities of the company, and that the court should be empowered to charge such liability upon the obligation due from the company to the director, or upon any other of the company's assets held by or vested in him or her or in any other person on the director's behalf.

5.3 Section 75, shortly after its enactment, became s 275 in the Companies Act 1929. The original section and its successors have been treated to as 'the most important incursion[s] into the principle of the separate personality of a company.'³ The section imposed both criminal and civil liability and in both civil and criminal proceedings the elements of the offence had to be established beyond reasonable doubt.⁴ Proceedings could be brought by the official receiver, the liquidator, creditors or contributories. Section 275 of the 1929 Act became s 332 of the Companies Act 1948, which was the result of the recommendations of the Cohen Committee in 1945.⁵ The pool of possible respondents to include those who had been guilty of fraudulent trading.

5.4 The Report of the Insolvency Law Review Committee, *Insolvency Law and Practice* (commonly known as, and similarly referred to here, as the 'Report')⁶ was of the opinion that the fraudulent trading provision as it stood in s 332 of the 1948 Act possessed significant inadequacies in dealing with responsible trading, such as the fact that the criminal burden of proof in civil actions and, also, applicants were required to establish actual fraud and real moral blame on the part of respondents.⁷

5.5 Consequently, the Cork Committee recommended that the provision be amended and that only criminal liability should apply in relation to fraudulent trading, with a new provision being introduced to allow for civil action. The legislature took up these proposals, partly, and enacted s 214 of the Insolvency Act 1986, which covered civil action for wrongful trading, and fraudulent trading was left to be covered by two provisions, namely s 213 of the Insolvency Act and s 458 of the Companies Act 1985.

5.6 The fact that civil liability was retained for fraudulent trading as well as criminal liability meant that the recommendations of the Cork Committee were not wholly implemented. But, unlike previous provisions, criminal liability was to be determined by a different provision, and this was s 458 of the Companies Act 1985 (now s 993 of the Companies Act 2006). The two provisions dealing with civil liability and the other dealing with criminal liability were essentially the same provision.⁸ The main differences are as to the question

proof, the order of the court and the fact that with s 993 there is no need for the company to be in liquidation.

5.7 While the pre-1986 decisions related to a provision that could lead to both civil and criminal consequences, the courts in post-1986 decisions have not uttered any caveats about relying upon, and employing, the older cases, and they certainly have not refused to hear argument based upon them. This seems reasonable given the fact that the provisions are very similar.

5.8 When ss 213 and 214 of the Insolvency Act 1986 were enacted, the latter was introduced to deal more with trading activity that was not fraudulent per se, but closer to negligent or irresponsible trading. Some of the discussion in this part overlaps with issues that are relevant to wrongful trading, which is discussed in Part C of the book.

5.9 Until recently an administrator was not empowered to bring fraudulent trading proceedings as s 213, and its precursors only covered liquidators. Now an administrator has power, under s 246ZA, to institute an action for fraudulent trading.⁹ The provision is in the same terms as s 213. For ease of exposition the book will refer, for the most part, to s 213 and to liquidators, but readers must be aware that what is said will usually apply equally to administration. There is no indication anywhere in the case law that s 246ZA will be interpreted any differently than s 213.

5.10 At one stage the civil fraudulent trading provision was little used and led one commentator to say that the section was virtually obsolete,¹⁰ but in the first decade of the twenty-first century, in particular, there was a renaissance and there were several important cases successfully brought by liquidators, and in the past decade there have been several cases, indicating that the action is not redundant.

5.11 Many Commonwealth jurisdictions, as well as Ireland, have enacted legislation akin to the UK's legislation, and so some case law from these jurisdictions can be helpful in examining the UK's provisions.

Aim

5.12 The paramount aim of s 213 is to compensate those who have lost out due to the actions of persons, who are identified in the section, engaging in fraudulent trading,¹¹ while the aim of s 993 is to punish by imposing penalties where the action is considered criminal. Also, the provisions are designed to prevent insolvent trading to the detriment of those who are induced to do business with the relevant company.¹²

³ R Williams, 'Fraudulent Trading' (1986) 4 *Company & Securities Law Journal* 14.

⁴ *Re Maidstone Buildings Ltd* [1971] 1 WLR 1085, 1094.

⁵ Cmnd 6659, [149].

⁶ Cmnd 858, HMSO (1982).

⁷ *Re Patrick and Lyon Ltd* [1933] Ch 786.

⁸ *Bernasconi v Nicholas Bennett & Co* [2000] BCC 921, 924.

⁹ This right came about through the enactment of s 117 of the Small Business, Enterprise and Employment Act 2015, which provided for a new section in the Act.

¹⁰ Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, 2002), 511.

¹¹ *Bank of India v Morris* [2005] EWCA Civ 693, [111].

¹² *R v Smith* [1996] 2 BCLC 109, 122(CCA).

Conclusion

5.13 The chapter has sought to provide an explanation of how the law has been developed to proscribe fraudulent trading and how it has been extended to include administrators as well as liquidators take action against directors and others who engage in fraudulent trading.

CHAPTER 6

Fraudulent Trading**The Provision and Its Scope****Introduction and Background**

6.1 As indicated in the last chapter, two provisions address fraudulent trading. They are the civil provision, s 213 of the Insolvency Act 1986 ('the Act') and the criminal provision, s 993 of the Companies Act 2006. They are essentially identical, with the primary differences being procedural. The standard of proof for a s 213 action is the same as for any civil proceeding, namely the balance of probabilities, while the standard for the criminal proceeding remains beyond reasonable doubt. The claimant in a civil claim is the liquidator, while criminal proceedings must be initiated by the Crown. It has been stated that decisions on s 993 are relevant to a consideration of s 213,¹ so in Part B no distinction is made between the cases on the basis of the provision under which they were decided. The main focus of this part is, however, on s 213, although, of course, many of things said here will be relevant to s 993, and occasionally reference will be made to the provision, either in the text or in footnotes. Also, there are a couple of sections of the chapter that include brief discussions of aspects of s 993.

6.2 This chapter involves an examination of the central elements of s 213, together with a discussion of the effect of its application. However, discussion of one of the main elements, and perhaps the most difficult element, of the provision, namely the need to establish intent to defraud or acting for any fraudulent purpose, is postponed, for the most part, to Chapter 7.

6.3 What s 213 provides is that if, in the course of carrying on a business, a company has done so either with intent to defraud the creditors or the creditors of anyone else or for any fraudulent purpose, a court may, on the application of the liquidator, declare that any persons who were knowingly parties to the carrying on of the business in such a manner are liable to make contributions (if any) to the company's assets as the court thinks proper.

6.4 At the outset we should note that at one time it was generally thought that s 213 would not be invoked very often, given the advent of the action of wrongful trading in s 214 of the Act, but that is not the case. While s 214 has a lower threshold of proof, and the elements of the section appear prima

¹ *Re BCCI; Banque Arabe Internationale D'Investissement SA v Morris* [2002] BCC 407, 413.

facie easier to establish, s 213 is far from being a dead letter. There have been several fraudulent trading actions in recent times. There have been and continue to be, a respectable number of prosecutions under the Companies Act, which is not, of course, affected by the provisions of the statute books.

6.5 Finally, in relation to interpretation, as mentioned earlier, there have been some changes in the present fraudulent trading provisions since the previous ones, it is clear that the cases decided under previous provisions relevant to proceedings taken under the present provisions,² although the cases have not been followed and some have even been overruled, of the reform of the provisions.

6.6 Furthermore, we should note that the interpretation of parts of the vexed courts and led the judge in one of the first reported cases under the first fraudulent trading provision, *Re Patrick & Lyon Ltd*,³ to say that the provision (in the 1929 Act) was "a very remarkable section and one which by no means easy to construe."⁴

The Elements: An Introduction

6.7 According to the decision in *Re BCCI; Morris v Bank of India*,⁵ there are three elements that constitute the action:

- the business of the company in liquidation has been carried on to defraud creditors or for any other fraudulent purpose;
- the respondent participated in the carrying of business; and
- the respondent did so knowingly.

6.8 As mentioned earlier, we will examine the first of these elements in a separate chapter, namely Chapter 7, as it has been an element that has been controversial and warrants its own chapter. The other elements are dealt with next.

6.9 In a case in which the criminal version of fraudulent trading was considered, *R v Wallace Duncan Smith*,⁶ the Court of Appeal actually set out the elements, which are roughly equivalent to what the court in *Re BCCI* and *Bank of India* propounded. They were: (1) the respondents were knowingly parties to the carrying on of the business; (2) there were creditors to whom the respondents intended that creditors should be defrauded; (3) the respondents carried on its business to the prejudice of the rights of creditors; and (4) the respondents were acting dishonestly.

² *Re L. Todd (Swancombe) Ltd* [1990] BCC 125.
³ [1933] Cr 786.
⁴ *Ibid.*, 789-790.
⁵ [2004] 2 BCLC 236, [11].
⁶ [1996] 2 Cr App R 1.

The Applicant

6.10 While individual creditors were able, under previous legislation, such as s 332 of the Companies Act 1948, to initiate applications for compensation on their own account, and it appears that a number of claims were initiated by persons other than liquidators,⁷ this cannot be done now,⁸ as only liquidators are entitled to apply for an order under s 213;⁹ applications are collective in that a liquidator is seeking compensation for the general body of creditors. Hence, courts are unable to direct that, as a consequence of fraudulent trading, a specific creditor be compensated for losses sustained.¹⁰

6.11 Arguably, the position that we have now in the UK is more equitable than was the former situation, as in the past one creditor who brought proceedings might be able to get paid following a fraudulent trading application, but as a result, the respondent might be placed in an impecunious state and, therefore, be unable to pay other creditors who either were slow in initiating proceedings or failed to do so.

6.12 Although creditors are not entitled to bring proceedings, they are not completely eliminated from the equation, as it is submitted that in some circumstances creditors could apply to the courts for a review of the decision of the liquidator if he or she chooses not to proceed with a fraudulent trading action. This could be done pursuant to s 168(5) of the Act for compulsory liquidations, and under s 112 for voluntary liquidations. But, of course, absent those situations where the threat of creditors to seek a court review may cause a liquidator to think again, creditors will have to expend time and money on court proceedings, and it might be thought that it is not worth doing so.

6.13 In the context of s 213, "liquidator" does not include a provisional liquidator, so the latter is not entitled to initiate proceedings.¹¹ Any proceedings will have to wait until the provisional liquidator or someone else is appointed as liquidator.

6.14 A liquidator of a limited liability partnership is empowered to bring proceedings under s 213 by virtue of the Limited Liability Partnerships Regulations 2001.¹²

6.15 Now, as we have noted previously, administrators are able to bring proceedings, but they are brought pursuant to s 246ZA of the Act. This broadens

⁷ For example, *In re Gerald Cooper Chemicals Ltd* [1978] Ch 262, *Re Cyona Distributors Ltd* [1967] Ch 889, 902, [1967] 1 All ER 281, 284 (CA).

⁸ In common with previous UK legislation, other jurisdictions permit a wider category of applicants who can bring proceedings against directors, including creditors and members, such as creditors and members as well as liquidators.

⁹ Administrators may bring proceedings under s 246ZA, a provision equivalent to s 213 and applying to administrators.

¹⁰ *Re Esal (Commodities) Ltd; London and Overseas (Sugar) Co Ltd v Punjab National Bank* [1993] BCLC 872 and affirmed on appeal: [1997] 1 BCLC 705 (CA); *Morphitis v Bernstein* [2003] EWCA Civ 289, [2003] Ch 552, [2003] BCC 540.

¹¹ *Re Overnight Ltd; Goldfarb v Higgins* [2009] EWHC 601 (Ch), [2010] BCC 787, [2010] 2 BCLC 186.

¹² SI 2001/1090 reg 5 and Sch 3.

the options available to administrators in bringing legal proceedings that a company would not have to be converted from an administrator to a liquidator merely to allow for proceedings under s 213 to be taken, a case before the advent of s 246ZA.

Applications

6.16 Fraudulent trading actions in civil law may only be initiated against a company in relation to whose affairs the actions are being brought, in liquidation (or administration). A reason for the limitation might be that it is not that companies not in liquidation would be solvent and action could be taken against the company itself.¹³ However, the fact that the company is solvent at the time of the success of its fraudulent activity.¹⁴ Also, it should be noted that s 213 does not require the company to be in insolvent liquidation, so the provisions could be invoked in relation to a company that has been wound up on other than an inability to pay debts, such as the just and equitable ground.

6.17 At one time liquidators were required, before taking action, to obtain approval from either the liquidation committee or the court, but that is no longer the case. The requirement of obtaining approval was abolished by s 122(1)(g) of the Small Business, Enterprise and Employment Act 2015, although liquidators should still take the view that it is prudent to obtain sanction in some cases, particularly where the case could involve a lot of expenditure, or the chances of success are small.

6.18 Proceedings that are brought under s 213 or s 246ZA are covered by the Insolvency Rules 2016. Liquidators and administrators who commence proceedings against directors would ordinarily complete Form 1AA with supporting witness statements.

6.19 The application is made in the insolvency proceedings commencing either liquidation or administration. It should seek a declaration under s 213 that the respondent has engaged in fraudulent trading and that the respondent is liable to make such contribution to the assets of the company as the court thinks fit.

6.20 On the filing of an initiating form (and supporting witness statements) the court will fix a return date, and this will usually involve a short appointment at which the court will give directions either as to witness statements, affidavits, or in a more complex case where pleadings are appropriate (where the court will often have provided draft points of claim), an order that the draft points of claim stand as points of claim followed by points of defence and points of reply. The matter will usually then come back to court for a further case management hearing to deal with disclosure, inspection, evidence and trial arrangements.

¹³ R Williams, 'Fraudulent Trading' (1986) 4 *Company & Securities Law Journal* 14.
¹⁴ *Ibid.*
¹⁵ Insolvency Act 1986, s 122(1)(g).
¹⁶ Often the parties will have previously agreed directions.

6.21 The section which addresses wrongful trading, s 214, contains a provision, s 214(8), that states that s 214 is without prejudice to s 213, so there is nothing to prevent a liquidator, in the appropriate case, from mounting proceedings which claim relief under s 213 and, in the alternative, under s 214. The liquidator in *Re Produce Marketing Consortium Ltd*¹⁷ commenced his action relying on both ss 213 and 214, and while the s 213 claim was dropped (clearly because the directors were not guilty of intending to defraud creditors),¹⁸ the judge did not comment adversely on the liquidator bringing proceedings under both of the sections. It was held in *Official Receiver v Doshi*¹⁹ in relation to an application under s 214, that such an application may be consolidated with disqualification proceedings, and there is no reason to think that it is otherwise where fraudulent trading is involved.

6.22 It is likely that in some situations liquidators may choose to couple a claim under s 213 with other claims, such as a claim under s 212 (misfeasance proceedings), as occurred, for example, in *Re Pantiles Investments Ltd (in liquidation)*,²⁰ arguing that directors have breached their duties.²¹ If a liquidator were to launch proceedings under both ss 213 and 212, the respondent's liability, if the liquidator succeeded, will be regarded as concurrent,²² except where the conduct leading to liability under each heading was different, and in such a case the court might order cumulative awards.²³ The difficulty that might arise where there is a concurrent award is that any award pursuant to s 213 is to be distributed amongst the general body of unsecured creditors,²⁴ while any award for causes of action brought under a s 212 summons goes to the company,²⁵ as the action for breach of duty is the company's and not the liquidator's, and this might enable a holder of a floating charge over company property to have priority in payment out of this latter award.

6.23 Claiming under s 213 involves an allegation of dishonesty, and so dishonesty must be pleaded in an application (and also put to the respondent in cross-examination).²⁶ The application should plead fraud clearly and with particularity,²⁷ that is, the actual conduct that constitutes an intent to defraud must be set out clearly.²⁸

¹⁷ (1989) 5 BCC 569.

¹⁸ *Ibid.*, 594.

¹⁹ [2001] 2 BCLC 235.

²⁰ [2019] EWHC 1298 (Ch), [2019] BCC 1003, [2019] 2 BCLC 295.

²¹ Often liquidators will rely on a breach of the director's duty to take into account the interests of creditors when the company was insolvent or close to it.

²² *Re DKG Contractors Ltd* [1990] BCC 903.

²³ *Re Purpoint Ltd* [1991] BCC 121, [1991] BCLC 491.

²⁴ Insolvency Act 1986, s 176ZB.

²⁵ *Re Anglo-Austrian Printing & Publishing Co* [1985] 2 Ch 891.

²⁶ *Dempster v HMRC* [2008] EWHC 63 (Ch), [2008] STC 2079, *Abbey Forwarding Ltd v Hone* [2010] EWHC 2029 (Ch). See *Three Rivers DC v Bank of England (No. 3)* [2003] 2 AC 1, [55], [160].

²⁷ *Re Augustus Barnett* (1986) 2 BCC 98,904, 98,908.

²⁸ *Morris v Bank of America National Trust* [2001] 1 BCLC 771 [2000] BCC 1076, [2000] BPIR 83 (CA) (an appeal relating to a strike out application). See *Ivy Technology v Martin* (2019) EWHC 2510, [12]; *Biscoe v Milner* [2021] EWHC 763 (Ch), [174].

6.24 The pleadings should include an averment that creditors of the company have sustained loss and what action caused the loss,²⁹ but unlike with fraudulent trading, where it is critical that the liquidator pleads a date from which the company is alleged to have commenced, courts have still held a respondent to be liable even if no date as to when the fraudulent trading occurred is stated where several alternate dates are alleged.³⁰

6.25 The application should plead that the respondent is responsible for a definite sum and not be liable in general terms.³¹

6.26 As a claim under s 214 can be made where a company is being wound up as an unregistered company,³² it is contended that a claim for fraudulent trading could also be made in the same circumstances where it is appropriate to do so.

6.27 The Supreme Court made it perfectly plain, in *Jetivia SA v Bilta (UK) Ltd*,³³ that the provision has extra-territorial effect in that it can be applied to individuals and companies that reside outside of the UK, so the respondent might not be in the country.

6.28 According to the decision in *Carman v Cronos Group SA*,³⁴ proceedings are not able to succeed under s 213 in relation to conduct that occurred between the date of the presentation of a winding-up petition and the making of a winding-up order, as a company cannot be regarded as carrying on business when any transaction in the course of that business which amounts to a disposition of property is deemed to be void under s 127 of the Act, unless the court orders to the contrary.

6.29 It was held in *Carman v Cronos Group SA*³⁵ that liability under s 213 may be imposed in relation to actions that occurred when the company had been dissolved but is later reinstated to the register. This was on the basis that s 653 of the Companies Act 1985 stated that a dissolved company when reinstated, was deemed to have continued in existence as if it had not been struck off the register.³⁶ This provision is effectively now found in ss 1028(1) and 1032(1) of the Companies Act 2006, and thus the *Carman* decision would still apply.

6.30 Funding an action is always a challenge for a liquidator or administrator when considering any action. One option is to get a litigation fund in bankroll proceedings. Another is to have the creditors indemnify the liquidator. A further option is to assign an action to an outsider for some consideration.

²⁹ *Goldfarb v Alibhai* (unreported, 11 December 2017, Business and Property Courts, London, [2017] 1 All ER 1000 (Barber)).

³⁰ *Re a Company No 001418 of 1988* [1991] BCLC 197.

³¹ *Re William C Leitch Bros Ltd* [1932] 2 Ch 71, 77–79; *Re a Company No 001418 of 1988* [1991] BCLC 197, 203.

³² *Re Howard Holdings Inc* [1998] BCC 549.

³³ [2015] UKSC 23, [2016] AC 1, [2015] 2 WLR 1168, [2015] 2 All ER 1083, [2015] 4 All ER 443, [13], [107], [110], [213].

³⁴ [2005] EWHC 2403 (Ch), [2006] BCC 451, [37].

³⁵ *Ibid.*, [24].

³⁶ *Ibid.*

one time a liquidator was unable to assign an action under s 213 because it was an action given to him or her personally in the position of liquidator,³⁷ but now things are different, as s 246ZD(2)(a) permits assignment of s 213 cases. This broadens the scope of what a liquidator can do to obtain some benefit from an action under s 213.

6.31 There is no law specifically on what the limitation period is for the commencement of an action under s 213, but it has been held in relation to s 214 that the application can be categorised as a claim in respect of a sum of money within s 9 of the Limitation Act 1980, and hence a six-year limitation period, from the date of the accrual of the cause of action, applies.³⁸ It is submitted that the view could be applied to s 213, as proceedings are of the same ilk as those under s 214. As a fraudulent action is personal to the liquidator any limitation period would commence to run from the time of the resolution to wind up in voluntary liquidations, or from the date of the court order in compulsory liquidations,³⁹ as they would be the respective points when the cause of action accrued. With s 246ZA and administrations the limitation period would run from the time when the administration commenced.

6.32 Unlike with actions under ss 238, 239 and 245 of the Act, for instance, liquidators are not limited in how far they go back in the life of the company to identify periods of fraudulent trading, but in practice the period subject to inquiry will usually be the couple of years prior to the advent of winding up.

6.33 It is somewhat uncertain as to whether a claim pursuant to s 213 would survive the death of a person allegedly liable under s 213, but who died before the initiation of proceedings. May it be continued against a director's estate in the event of the alleged wrongdoer's death? In a wrongful trading case, *Re Sherborne Associates Ltd*,⁴⁰ it was said that as far as s 214 there was reason to suppose that Parliament had intended that such a claim should not be defeated by death,⁴¹ but in that case the judge issued the caveat that if the director had lived, he or she might have been able to provide a credible explanation for what had been done or not been done, and consequently a judge should have in mind the fact that the director might have been able to rebut the liquidator's claims had he or she lived.⁴² It might be submitted that the comments of the judge in *Re Sherborne Associates Ltd*⁴³ are even more pertinent with respect to a s 213 action, as in this kind of action an intent to defraud has to be established and a director should be given the opportunity to challenge any allegations of fraud made against him or her and to be able to give evidence that he or she had no intent to defraud. However, this might

³⁷ *Re Oasis Merchandising Services Ltd* [1995] BCC 911.

³⁸ *Re Farmizer (Products) Ltd* [1997] 1 BCLC 589, 598, CA.

³⁹ *Re Overnight Ltd (In Liquidation)* [2009] EWHC 601 (Ch), [2010] BCC 787, [2010] 2 BCLC 186, [36].

⁴⁰ [1995] BCC 40.

⁴¹ *Ibid.*, 46.

⁴² *Ibid.*, 47.

⁴³ *Ibid.*