CAREY OLSEN

Zone of insolvency – directors in the firing line

Service area / Restructuring and Insolvency
Location / Guernsey
Date / January 2019

Happy New Year?

2018 saw a number of high profile insolvencies around the world, including in Guernsey. The climate for many sectors remains extremely challenging with the UK further hindered by continuing uncertainty around Brexit. EY's Profit Warning Stress Index hit its joint highest level for two years in the third quarter of 2018 with 68 UK quoted companies issuing profit warnings.

At no time in recent history has the scrutiny placed on directors and their conduct in the build up to a collapse been so intense. The importance of understanding and managing a director's duties in times of financial distress cannot therefore be overstated.

Focus on decision making and a US$2 billion claim

Directors owe duties to the company they serve. In the normal course, they 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 position of the company's creditors. In those circumstances, directors still owe their duties to the company but must discharge them predominantly with the interests of creditors in mind.

The scrutiny applied to that shift in focus becomes sharpest when a company has failed and been placed into liquidation pursuant to Part XXIII of the Companies (Guernsey) Law, 2008, as amended (the **Companies Law**). In certain circumstances, a liquidator may seek orders from the Court that an officer must 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.

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.

The basics

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

i. act bona fide in the best interests of the company;

ii. act for proper purposes/not to act for improper or collateral purposes;

iii. exercise independent judgement; and

iv. avoid conflicts of interest.

Whether a director has fulfilled his fiduciary duties to the company will be tested (predominantly) subjectively, that is to say, it is contingent upon the director's state of mind.

A directors' duty of skill and care, however (which is a non-fiduciary duty), is measured both objectively and subjectively[1]. In determining the scope of the duty, a court will consider:

i. the director's **actual knowledge**, skill and experience (subjective test); and
ii. 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 (as was once the position at common law), but instead, 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, the benchmark for undertaking corporate affairs is measured against reference to the 'solvency test' adopted in section 527(1) of the of the Companies Law which provides that a company will satisfy the solvency test for the purposes of the Companies Law if *inter alia*:

i. it is able to pay its debts as they become due (the **Cash Flow Test**); and
ii. 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, in order to pass the solvency test a company must pass both the Cash Flow Test and the Balance Sheet Test.

Any analysis of balance sheet solvency must include consideration of contingent and prospective liabilites. 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, with hindsight, be scrutinised from the perspective of damage done to creditors.

Potential actions

Preferences

A liquidator may apply to the court for an order to set aside a transaction entered into by a company if (a) it was entered into at a time when the company was insolvent or (b) the company 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:

a. "*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**

b. 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 was (and ultimately the directors as decision makers were) influenced by the necessary "desire" to prefer. In practice, establishing a desire to prefer will be a factual exercise to show that the company was influenced by an intention to produce the result of putting 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 make any order it thinks fit to restore to the position of the company to where it would have been absent the preference. The range of possible orders includes making directors personally liable.

Transactions at an undervalue

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

One possibility is to claim that the directors committed an equitable wrong, *i.e.* establish that the recipient of the company's assets had knowledge that the directors were acting in breach of their fiduciary duties (by selling company assets at an undervalue) and that the knowledge was such that the recipient's 'conscience' was so affected that it would be impermissible to allow them to retain the misappropriated asset. As such, a claim may be founded by suggesting the recipient was a constructive trustee of the company's assets.

Another possibility may be for a liquidator to bring a customary law *Pauline* action[2]. In essence, a *Pauline* action 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.

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

Continued

The rationale of the *Actio Pauliana* is that - "... i*f a person has alienated his property in fraud of creditors who have been put in possession by order of the governor, 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.*[3]"

The critical elements to such an action would be that:

a. the debtor must have been insolvent on a balance sheet basis at the time of the transaction; and

b. 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[4], the remedy for which is restitutionary in nature meaning that, if the action is successfully established, the transfer of assets is set aside such that the assets become available to satisfy the creditor's claim. There is no entitlement to compensation.

Misfeasance/breach of fiduciary duty

Where in the course of the winding up of a company it appears that any director (a) has appropriated or otherwise 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 in relation to the company, the liquidator (**or any creditor or member of the company**) may apply to the Court for an order against the director in his personal capacity. Any claim must be brought within six years from the date of breach.

As noted above, the test for a breach of fiduciary duty is a subjective one. In the case of *Carlyle Capital Corporation Limited (in Liquidation) and others v. Conway and others*[5], 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, and that therefore a claim for breach of fiduciary duty will only lie where it is shown that the directors did not honestly consider their action to be in the best interests of the company*"[6].

If a claimant is successful in proving misfeasance or a breach of duty, the court may order the delinquent director to (a) repay, restore or account for such money or property; (b) contribute sums towards the company's assets; (c) pay interest upon such amount, at such rate and from such date; as the court thinks fit in respect of the default, whether by way of indemnity or compensation or otherwise[7].

Wrongful trading

Where a company has gone into insolvent liquidation at some time before the commencement of the winding up of the company, and a director knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into 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 to minimise the loss to creditors, and such action was taken at the appropriate time.

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 turn around dictate that trading should continue.

The sanction against wrongful trading is not designed to punish the honest director who takes a reasonable decision to continue a company's life with the long term benefit of creditors in mind. It is intended to punish those that carry on with no reasonable expectation of improvement and in doing so increase the net deficiency in the company's assets in the subsequent 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 the carrying on of the business in that matter is guilty of an offence.

If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors, the liquidator may apply to the Court for an order that the director 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, it can be inferred that the company is carrying on business with intent to defraud.

3 Jersey & Guernsey Law Review – February 2008, ' Restitutionary Weapons in the Fight Against Fraud', para 21.
4 Morgan v Donaldson (18 July 1985) and Le Ray v Martel (7 July 1747)
5 [2017] Civil Action No. 1510.
6 At para 379.
7 section 422(3) of the Companies Law.

Continued

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 all of the circumstances, he ought fairly to be excused for either wholly or partly from his liability.

It should be noted that any proposal that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company may be void.

Disqualification

The Court may make a disqualification order[8] where it considers that, by reason of a person's conduct in relation to a company or otherwise, 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 when considering whether a person is unfit for office:

i. whether the director has been held liable to make contributions to a company's assets under section 433, 434 or 435;

ii. the director's conduct in connection with any company that has gone into insolvent liquidation; and/or

iii. 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 in question 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 especially vital that they understand the nature of their duties, and how to discharge those duties, 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 future of 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.

In times of financial uncertainty, directors should be increasingly mindful of the need to properly minute decision making and the supporting rationale for it and also seek advice, where necessary, from suitably qualified advisors.

Carey Olsen Restructuring and 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.

For further details of our capabilities please click here.

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.

FIND US

Carey Olsen
PO Box 98
Carey House
Les Banques
St Peter Port
Guernsey GY1 4BZ
Channel Islands

T +44 (0)1481 727272
E guernsey@careyolsen.com

FOLLOW US

Visit our restructuring and insolvency team at careyolsen.com

Please note that this briefing is only intended to provide a very general overview of the matters to which it relates. It is not intended as legal advice and should not be relied on as such. © Carey Olsen (Guernsey) LLP 2019