The zone of insolvency – a guide for directors in Guernsey

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Fallout from the global pandemic continues to throw light on the responsibilities of directors in times of financial distress. This briefing examines those duties in greater detail, particularly in relation to Guernsey's company law.

Decisions, decisions

Directors owe duties to the companies they serve and ordinarily discharge those duties with reference to the interests of the companies' members as a whole.

When a company is "in the zone of insolvency", however, the actions (or inactions) of directors have the potential to prejudice that company's creditors. In those circumstances, directors must discharge their duties predominantly with the interests of the creditors in mind. There have been multiple formulations by judges of the precise time at which the so called "creditors duty" arises so as to shift the focus of a director's decision making. For Guernsey purposes, the duty will arise when a company is very close to insolvency and the decisions made are likely to impact its creditors.

The scrutiny applied to that shift in concentration becomes sharpest when a company is placed into liquidation in accordance with the *Companies (Guernsey) Law 2008*, as amended. In certain circumstances, a liquidator may ask a court to order an officer to 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.

A practical example would be the claims of circa US$2 billion (£1.52 billion) made by the liquidators of Carlyle Capital Corporation Ltd against its former directors in relation to their conduct in the build-up to the firm's collapse in the early stages of the global financial crisis of 2007-8. Whilst unsuccessful, those claims and countless others around the world have demonstrated the importance for directors in understanding their duties in times of distress and taking the right steps at the right time to protect themselves from personal liability.

The basics

Directors owe both fiduciary and non-fiduciary common law duties to the companies they serve. The fiduciary duties oblige each one to:

- act *bona fide* in the best interests of the company;
- act for proper purposes and to not act for improper or collateral purposes;
- exercise independent judgment; and
- avoid conflicts of interest.

A court will decide whether a director has fulfilled his fiduciary duties to the company subjectively, or at least predominantly so, concentrating on the director's state of mind.

A director's duty of skill and care (a common law duty), however, is measured both objectively and subjectively in Guernsey. This is also the situation in the UK as codified under *s214(4) Insolvency Act 1986*. In determining the extent of the duty, a court will consider the director's actual knowledge, skill and experience (the subjective test); and the knowledge, skill and experience that may be expected of someone acting as a director (the 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 if 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, *s527(1) Companies Law* states that a company will satisfy the solvency test if, among other things, it is able to pay its debts as they become due (the cash-flow test) and if the value of the company's assets is greater than the value of its liabilities (the balance-sheet test).

The solvency test is cumulative, so the 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. Although the law in that area is complicated 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.

Against this backdrop, we look at various types of potential action that sundry parties may take that affect directors.

Preferences

A liquidator may apply to a court for an order to set aside a transaction if it the parties agreed to it at a time when the company was insolvent or if 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 com¬pulsory winding-up (or a resolution for voluntary winding up) is "vulnerable" in the sense that it could be set aside.

A company is deemed to have given a preference to a person if: (i) 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 (ii) 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. Anyone who wants to establish such a desire will have to prove that the company was influ¬enced 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 anyone has given anyone else a preference, the court has wide-ranging powers to restore the company to the position it would have been in if the preference had never happened, and indeed to make the directors personally liable.

Transactions at an undervalue

Although there is currently no codified law relating to transactions at an undervalue (as in the UK although draft legislation is being progressed), 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 knew about the directors' breach of fiduciary duties (by selling assets at an undervalue). It could then be claimed that the retention of the assets by the recipient as constructive trustee ought to be impermissible.

Alternatively, a creditor may bring a customary law "Pauline" action, 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 availability of this action was recognised in Guernsey by Lieutenant Bailiff Southwell QC in *Flightlease Holdings (Guernsey) Ltd v International Lease Finance Corporation (2004).*

The rationale of the *Actio Pauliana*, according to para 21 of the February 2008 edition of the *Guernsey Law Review*, 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."

For this to happen, it is imperative that: (i) the debtor must have been insolvent on a balance-sheet basis at the time of the transaction; and (ii) 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 making a claim in Guern¬sey is six years. Two Guernsey cases – *Morgan v Donaldson* (18 July 1985) and *Le Ray v Martel* (7 July 1747) – have been decided on principles akin to the Pauline action, the remedy for which is restitutionary in nature. This means 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

If, 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 a court for an order against the director personally. As noted above, the test for a breach of fiduciary duty is a subjective one. Claims may also be brought under the common law for breaches of duty.

In the case of *Carlyle Capital Corporation Limited (in Liquidation) and others v Conway* and others, HH Marshall LB held that: "There is no fiduciary duty to make an objectively 'right' decision"; and "a decision (whether right or wrong)

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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."

If a claimant is successful in proving misfeasance or a breach of duty, *s422(3) Companies Law* says that 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.

Wrongful trading

If 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 courts for a declaration that the director is liable to contribute to the company's assets.

It will, however, be a defence for a director to demonstrate that they 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 the automatic trigger for an insolvency process and there are circumstances in which the reasonable belief and prospect of an improvement, restructuring or turnaround dictate that trading should continue.

The sanction against wrongful trading is not de¬signed to punish the honest director who takes a reasonable decision, but rather to punish one who carries on with no reasonable expectation of improvement and, in doing so, diminishes the net assets of the company in an insolvency.

Fraudulent trading

According to *s432 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 a court for an order that forces the director(s) to 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

According to *s522 Companies Law*, a court may relieve a director of liability if, in proceedings for negligence, default, breach of duty or breach of trust, it appears that he 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

A court might issue a disqualification order if it considers that a person, by reason of his conduct, is unfit to be concerned in the manage¬ment of a company. Pursuant to *s428(3) Companies Law*, the court may, amongst other things, have regard to the following:

- whether the director has been held liable to make contributions to a company's assets under *ss433, 434 or 435*;
- the director's conduct in connection with any company that has gone into insolvent liquidation; and/or
- 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 made by, *inter alia*, the Guernsey Financial Services Commission, the Registrar, any company of which the person is or has been a director or has participated in its management, any liquidator, administra¬tor, member or creditor of such a company any other interested party with the leave of the court.

A disqualification order may prohibit a person from, among other things, (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.

Perpetual monitoring

A company's officers should monitor its financial state perpetually, but it is vital for them to under¬stand the nature of their duties and know how to discharge them when the company appears to be "in the zone of insolvency". The way in which officers conduct themselves in such circumstances may have significant implications not just for the company, its members and creditors, but also for these officers. If they have failed in their duties, their conduct may be called into question and this could lead to personally liability. At such times directors should ensure that they have detailed, quality information available to them to allow them to make "good" decisions and keep comprehensive and accurate records of the decisions taken and reasons for them.

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