International Corporate Rescue

ChaseCambria
SOUTH SQUARE
Centre for Commercial Law
UCL LAWS

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2017 (6 issues)
Print or electronic access:
EUR 730.00 / USD 890.00 / GBP 520.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

Directors' Duties in the Twilight Zone

Katharina Crinson, Senior Knowledge Lawyer, and **Rachel Seeley**, Solicitor, Freshfields Bruckhaus Deringer LLP, London, UK

Synopsis

In *Ball (Liquidator of PV Solar Solutions Ltd), PV Solar Solutions Ltd (in CVL) v Paul James Hughes, Martyn Paul Ware* [2017] EWHC 3228 (Ch) the High Court held that credit entries made against two directors' loan accounts at a time when creditors were being left unpaid were in breach of the directors' fiduciary duty to act in the best interest of the company. The directors were ordered pursuant to s. 212 of the Insolvency Act 1986 to repay the sums with compound interest.

Background

The company traded in the supply and installation of solar panels. For a number of years it achieved great success, benefitting from a government scheme known as the 'feed in tariff' (FIT) which made it attractive for consumers to install solar panels. Following policy changes, the government announced in 2011 that the FIT for small scale solar panel installations of the type carried out by the company would more than halve, with the reduction taking effect in March 2012. The company suffered cash flow difficulties as a result, as fewer people commissioned the installation of solar panels, and eventually entered administration in May 2013 and creditors' voluntary liquidation in November 2014.

Just before the reduction of the guaranteed FIT took effect (thus making the installation of solar panels far less attractive), the directors decided to pay themselves a 'bonus'. It was agreed with the company's accountant that the bonus should be treated in the company's records as a director's loan 'which would be converted into a dividend when finalising accounts later in the year'. This was repeated a number of times, totalling payments of £65,900 and £71,400 for each director respectively. The directors then awarded themselves three credits (the 'Credits') to be set off against the loan account debit balance, totalling £750,800. At the same time, the directors caused the company to incur substantial debts to a supplier, which were never repaid. The liquidators challenged the Credits.

Judgment

Duty to act in the best interests of creditors

Where a company is insolvent or of dubious solvency, the duty to act in the best interest of the company is regarded as a duty to act in the interests of its creditors as a whole (see *Re HLC Environmental Projects Limited* [2013] EWHC 2876 (Ch)).

The judge analysed *Re HLC* as well as the cases on balance sheet and cash flow insolvency (*BNY Corporate Trustee Services Ltd v Eurosail* [2013] UKSC 28 on the former and *In re Cheyne Finance Plc (in receivership) (No. 2)* [2007] EWHC 2402 (Ch) and *Re Casa Estates UK Ltd (in liquidation)* [2013] EWHC 2371 (Ch) in relation to the latter). She concluded that the 'underlying principle is that directors are not free to take action which puts at real (as opposed to remote) risk the creditors' prospects of being paid, without first having considered their interests rather than those of the company and its shareholders' (paragraph [72]). References to 'dubious' solvency must be seen in light of this underlying principle – the doubt is not a reference to a mathematical calculation and is not a snapshot test. Instead, the test is wider than that: 'the court must ask itself (...) whether, at the time of (or as a result of) the director's actions, there is a real risk of the company's creditors being left unpaid' [at paragraph 73]. The court recognised that in some circumstances this might involve considerations of the wider context in which the company operates, significant trading events and/or trading models.

Is the duty objective or subjective?

The duty imposed on directors to act *bona fide* in the best interest of the company (or its creditors where solvency is in doubt) is a subjective duty – but subject to three qualifications:

– Where the duty extends to creditors (because solvency is doubtful), their interests must be considered as paramount.

- The subjective test only applies where directors actually considered the best interest of the company. If there is no such evidence then the test is objective – whether an intelligent and honest person in the position of a director could have reasonably believed that the transaction was for the benefit of the company.
- Where there is a very material interest (e.g. a large creditor) which is without justification overlooked, the objective test must be equally applied.

The Duomatic principle

The directors did not have contracts of employment with the company. The company's articles provided that the directors be entitled to such remuneration as the company may by ordinary resolution determine. The court found that no such determination had been made by the shareholders. Therefore, any remuneration drawn by the directors was *prima facie* in breach of the company's articles.

The directors argued that as the sole shareholders of the company, their actions could constitute the required shareholder resolution under the *Duomatic principle* (*Re Duomatic Ltd* [1969] 2 Ch 356). However, the court found on the evidence before it that the directors never applied their minds to the question of whether to ratify the Credits made as remuneration; quite the contrary, the directors' efforts were focused on extracting the monies by other means. Indeed, even if the court was wrong on this on the facts, it was common ground that the *Duomatic principle* does not apply where a company is insolvent or rendered insolvent by the impugned transaction and that the party who wishes to rely on the *Duomatic principle* would need to prove to the court on the balance of probabilities that the company was solvent at the time. The court was not so satisfied.

Quantum meruit

The directors lastly argued that they should not have been expected to work for nothing and so should be entitled to the sums on a *quantum meruit* basis (if nothing else). Counsel relied on the decision in *Global Corporate Ltd v Hale* [2017] EWHC 2277 (Ch) (reported in *International Corporate Rescue*, volume 15 issue 2).

The court held that the decision in *Global* to allow a director a sum by way of *quantum meruit* on unjust enrichment grounds is open to question. For present purposes the case was sufficiently distinguishable on the facts.

The outcome

The court found that the directors had caused the company to incur substantial liabilities (the Credits) 'out of thin air', so that they could then be set off against the directors' respective loan accounts.

The first of the Credits had been paid pursuant to a purported tax saving scheme known as Lazarus, following very detailed steps which were outlined in the board minutes. In relation to the second two Credits, the court noted that these were applied to the loan accounts 'without even the fig leaf of Lazarus' [paragraph 129]. The court in this case was not concerned with establishing the legality or otherwise of the Lazarus scheme.

The court found that the directors acted in breach of their fiduciary duty to act in the best interests of the company's creditors, misapplied the company's assets for their own benefit and failed to exercise their powers for proper purposes. They were therefore misfeasant and were ordered to repay the amount of the Credits to the liquidation estate.

Comment

Any analysis of whether a company is cash flow and/or balance sheet insolvent necessarily rests on the facts of the individual case (and indeed, nine pages are devoted to the analysis in the judgment). This case summary is not concerned with the detailed analysis that the court undertook to conclude that the company had in fact been insolvent at the time of each of the Credits.

However, the judgment provides a very useful summary of the directors' duties regime and how it fits in with the insolvency regime which will be helpful to practitioners.

As the authors of the *Global* article stated in that article, that case was a case of a sympathetic judge doing what he could in circumstances where the justice of the case clearly merited the conclusion (albeit the fact that the decision itself does not stand up to judicial scrutiny, as demonstrated in this case). Not every case will be able to proceed on this basis. In the present case the court had very little sympathy with the directors who clearly ignored their duties as directors and preferred their own interests to those of the company and its creditors. Indeed, the court stated that on the evidence at least one of the directors admitted that he had not heard of cash flow insolvency until the commencement of the proceedings. Such ignorance did not excuse the directors.

As far as lessons learned when advising directors, it is clear that directors should have clear contractual arrangements that set out the basis and structure of their remuneration, so that later arguments on the *Duomatic principle* or *quantum meruit* unjust enrichment can be avoided.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, US Corner, Economists' Outlook and Case Review Section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com