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Judge refuses liquidator's wrongful trading application

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Banking & Finance/Commercial/Corporate Crime/Dispute Resolution/Financial Services/In-House Advisor/Restructuring & Insolvency:
David Bowden, a solicitor-advocate of David Bowden Law, notes the decisions in *Re Ralls Builders Limited*, and talks to Andy Whelan, a licensed insolvency practitioner and partner in WSM Marks Bloom LLP in Kingston upon Thames and David Oliver from Verizona Law in Portsmouth (who acted for the successful directors) about what lessons can be learned from this case.

Original news

Grant & Tickell (Joint liquidators of Ralls Builders Limited) v. Ralls, Ralls & Hailstones
[2016] EWHC 1812 (Ch) 20 July 2016
[2016] EWHC 243 (Ch) *11 February 2016*
High Court of Justice, Chancery Division, Snowden J

A High Court judge refused to grant an application made by a liquidator. The liquidator claimed that an insolvent company had engaged in wrongful trading. In February 2016 in a reserved judgement after a 15 day trial, Snowden J dismissed the liquidator's claim and ruled in favour of the former directors of the insolvent company. Following a consequential orders hearing, Snowden J has handed down another judgment dismissing the liquidator's claim to recover £250k of their costs and expenses. He also refused to make a director's disqualification order against any director.

What was the background to the application, briefly?

David Bowden (DB): The joint liquidators of Ralls Builders Limited ('Ralls') commenced proceedings against Ralls' directors for wrongful trading under section 214 of the Insolvency Act 1986 ('IA'). The amount claimed originally was in excess of £1.13 million, but was reduced by the end of the trial to somewhere between £600,522 and £987,725.

Ralls was a construction business and operated profitably in the years up to 31 October 2008. However in the year to 31 October 2009 it:

- made trading losses,
- suffered from business disruption in the winter months of January/February 2010,
- incurred substantial liabilities to Hampshire County Council as a result of defective works performed by a sub-contractor, and
- had to make significant adjustments to its accounts which were attributed to non- recoverable expenditure for the benefit of a local football club (Fareham).

When the draft audited accounts for year ending 31 October 2009 were produced in June 2010, it was apparent that Ralls was insolvent and it was also suffering severe pressure from numerous trade creditors and HMRC, whom it was failing to pay as the debts fell due.

The Joint Liquidators contended that by the end of July 2010 (or at the latest by the end of August 2010), the directors ought to have realised that Ralls' losses and balance sheet deficit were sufficiently large that it had no reasonable prospect of avoiding insolvent liquidation and ought to have ceased trading. They allege that Ralls' financial records were inadequate such that the directors could not reliably monitor the effect upon creditors of continuing to trade. A consequence of Ralls carrying on business was that the secured debt to its bank (Bank of Scotland) was eliminated as a result of receipts from completion of contracts. However new unsecured credit due to trade creditors was never paid. As the directors had given no personal guarantees to Ralls' bank, they did not stand to benefit personally by any reduction in Ralls' secured lending.

The directors denied that at any time until they made a decision to put Ralls into administration in late September 2010 they either knew (or ought to have concluded) that there was no reasonable prospect of avoiding an insolvent liquidation. The directors contend that throughout the relevant period (that is from the end of July 2010 onwards) they were taking steps which had a reasonable prospect of rescuing Ralls and avoiding an insolvent liquidation.

This included an attempt to persuade a seemingly wealthy third party (Mr James) to acquire a total of 25% of the Ralls' parent company (Dylex) by way of acquisition of existing shares for £1.5 million and the subscription of £1 million for new shares. This £1 million was to be injected by the parent into Ralls to restore its balance sheet and enable it to pay pressing creditors. The directors submitted that they took the view that continued trading during the summer months would be profitable, would enable the completion of contracts and maximise recoveries from customers, and hence that it would not worsen the position of creditors overall whilst they attempted to finalise a deal with Mr. James.

What were the main legal arguments put forward at trial?
DB: The liquidators applied for a declaration that on or about 31 July 2010 or 31 August 2010 the directors knew or ought to have concluded that there was no reasonable prospect that Ralls would avoid going into insolvent liquidation. They contended that those directors caused Ralls to continue to trade wrongfully and to incur further credit with unsecured trade creditors until it was finally placed into administration on 13 October 2010.

The liquidators sought a declaration that the directors were liable to make a contribution to the Ralls' assets in respect of the diminution of net assets or the losses to unsecured creditors sustained during that period of continued trading. IA section 214(3) contains a limitation on the circumstances in which a court can make a declaration under section 214(1).

The former directors submitted there was no unlawful trading. They submitted evidence, including that of an expert, which showed that the company had indeed traded profitably over the summer months. This evidence showed that the financial position of the business had actually improved by over £30,000. They also led evidence as to their failed attempt to get Mr James to buy into the business and submitted that this was also a step taken by them to try to save their company and had to be given a chance to work.

What did the judge decide in his February 2016 ruling?
DB: The judge ruled that the involvement of Mr Tickell (a licensed insolvency practitioner) in late July/early August was highly significant. He said that the approach which Mr Tickell took (confirmed in his letter of 6 August 2010) as regards the prospects of obtaining an investment from Mr James, '*must be fatal to the Joint Liquidators' case that as at 31 July 2010 the Directors ought to have concluded that there was no reasonable prospect of the Company avoiding an insolvent liquidation. In short, the Directors sought and received expert advice from Mr. Tickell on 2 and 6 August 2010, which was to the effect that they were not then trading wrongfully, and I do not think that I have a sufficient basis to reach a different conclusion.*'

Accordingly the judge refused the joint liquidator's application. He ruled that the function and the wording of the two subsections of IA s 214 were different. Section 214(1) provided for a financial remedy in effect to restore the financial position of the company to what it would have been had the wrongful trading not occurred and focused on the consequences of wrongful trading for unsecured creditors as a whole. On the other hand IA s214(3) focused on the regime which the director put in place to protect creditors after the relevant time, rather than the result.

Given the express wording in IA s214(3) ('*every step'*) it was plain that section 214(3) was intended to be a high hurdle for directors to overcome. It had to be construed strictly and required a director who wished to take advantage of the defence to demonstrate not only that continued trading was intended to reduce the net deficiency of the company, but also that it was designed appropriately so as to minimise the risk of loss to individual creditors. Otherwise a director could make out the defence under s214(3) by claiming that he traded on with a view to reducing the overall deficiency by creditors as a general body, irrespective of how he achieved that result as between creditors.

Whether or not the directors succeeded in reducing the net deficiency of the company as regards its general body of unsecured creditors, they ought not be entitled to an outright defence under section 214(3) on the facts of the case. However, the continuation of trading by the directors trading after 31 August 2010 had not caused any, or any material, increase in the net deficiency of the company.

What happened at the March 2016 hearing?
DB: This contested hearing took another 2days to deal with the following 2 issues:

- Whether, in the light of the judge's ruling that there was no wrongful trading, he should nevertheless make a declaration that the directors should make a contribution to the assets under IA s214(1) in respect of the costs and expenses of the administration and subsequent liquidation of the Company, and
- What order, if any, to make against the former directors under section 10 of the Company Directors Disqualification Act 1986 ('CDDA').

What did the judge decide in his July 2016 ruling on contribution to costs and expenses?
By the March 2016 hearing, the joint liquidators had put in a witness statement claiming a contribution to their expenses of just over £256k and exhibited extracts from their firms' time ledgers. The former directors said there was no such power to order a contribution. The judge preferred these latter submissions upholding the general rule that expenses incurred by or on behalf of a litigant in investigating and bringing a claim are not recoverable by way of damages. He rules that these sums cannot be recovered by way of damages for breach of contract or tort.

Applying *Avrahami* **[2013] EWHC 1776 (Ch)** Snowden J says there should not be '*an exception to the general rule… to cater for costs incurred in relation to litigation by insolvency office-holders*.' Further he agrees with Warren J in *SISU Capital Fund v Tucker* **[2006] BCC 463** where he said:

> '40. *Further, the position of an office-holder is, in my judgment, no different. It may be the case that, in the fulfilment of his duties as an office-holder, he has to bring or defend litigation. The fact that he does so does not mean that it is part of his profession to conduct litigation in the way that it is part of the profession of a solicitor to do so….. That sort of duty on the part of an office-holder or other fiduciary does not, in my judgment, afford any basis for a difference in treatment, vis-à-vis the payment of costs by an opposing party, from any other litigant.'*

Finally Snowden J rules that for an office holder to be able to validly claim any of their costs and expenses, then the acts of the directors must have caused these to have been incurred in a legal sense. He says this is more than just a 'but for' test. He agrees with Park J in *Continental Assurance* **[2001] BPIR 733** where he said: '*There must, in my view, be more than a mere 'but for' nexus of that type to connect the wrongfulness of the directors' conduct with the company's losses which the liquidator wishes to recover from them.*'

Did the judge order any of the directors to be disqualified?
No. The power under the CDDA is only triggered where a court has made a declaration that a person is liable to contribute to a company's assets under IA s214(1). Snowden J concludes that as he has not made any order for contribution, '*the jurisdiction to make a disqualification order….does not arise.*'

To what extent is the judgment helpful in clarifying the law in this area?
DB: There are 3 previous judgements that help Snowden J shape his interpretation of IA s214(3):

- *Re Kudos Business Systems* **[2011] EWHC 1436 (Ch), [2012] 2 BCLC 65** (Deputy Judge Sarah Asplin QC),
- *Continental Assurance Co of London PLC* **[2007] 2 BCLC 287, [2001] BPIR 733, [2001] All ER (D) 229 (Apr), (**Park J), and
- *Re Purpoint* **[1991] BCLC 491, [1991] BCC 121, (**Vinelott J).

Snowden J probably went a little bit further in his interpretation of IA s214 than in previous cases. He ruled at paragraph 186 (of the February judgement) that: '*But in my judgment, just as knowledge that the Company was insolvent does not mean that the Directors knew or ought to have concluded that an insolvent liquidation was inevitable,'.* Snowden J says that: '*the real issue as regards section 214(1) is whether, and if so, when, the Directors ought to have concluded that there was no reasonable prospect of completing a deal with Mr. James. This requires consideration of what a reasonably diligent person having the same general knowledge, skill and experience as the Directors, would have known and concluded.'* Snowden J gave the directors the benefit of the doubt in accepting they '*were builders who were not professionally trained in financial* matters'.

Snowden J sums up the authorities and his approach in this way:

> '*I therefore conclude that the correct approach to determining whether the Directors should be required to make a contribution under section 214(1) is, as the Directors contended, to ascertain whether the Company suffered loss which was caused by the continuation of trading by the Company after 31 August 2010 until the Company went into administration on 13 October 2010, and that as a starting point this should be approached by asking whether there was an increase or reduction in the net deficiency of the Company as regards unsecured creditors between the two dates. I think that the authorities to which I have referred also make good the submission on behalf of the Directors that there has to be some causal connection between the amount of any contribution and the continuation of trading'*

What will happen next with this case?
David Oliver (DO): Snowden J refused an application by the liquidator for permission to appeal when he handed down his July 2016 judgement. There will be a 3rd hearing to be listed in the autumn term to deal with costs and payment on account pending detailed assessment.

What practical lessons can those advising take away from this case?
DB: The business was advised by Mr Tickell. He was diagnosed with cancer and the judge dismissed an application to adjourn the case until he was better. Mr Tickell had been meticulous in his work. Whilst he had attended meetings with the directors throughout the period leading up to its eventual collapse, he had sent the directors detailed letters of advice. These included warnings on the risk of a wrongful trading claim. Those advising insolvent or potentially insolvent businesses should continue to give warnings about the risks and consequences of unfair trading.

Here the directors were able to show from their books that during the summer they had traded profitably. This entailed a detailed examination of their books and the assistance of an expert to bring out the true financial position. The maintenance of good books by a business in the period before an insolvency will be vital to show whether a liquidator can indeed make good on the facts a claim under IA s214.

The judge refers to a business being given '*a limited period to succeed'* but there is no quantification as to how long that period will be. Finally the judge decides that directors who continue to draw a salary during a period before there is a formal insolvency step should not be deprived of a s214 defence. He says directors are entitled for pay for work actually done '*provided that they were genuine salaries and not excessive in amount'*.

Andy Whelan: I find that wrongful trading is something that particularly concerns some (although by no means all) directors when I am first advising them. My advice is that simply ceasing to trade and liquidating - which is often perceived as the easy option - is not necessarily in the best interests of creditors if there is a genuine prospect of recovering the situation. I also caution that directors could just as easily be criticised for failing to pursue such a prospect. This case is a helpful confirmation that, even if guilty of wrongful trading, the directors are only liable to contribute to the assets of the company to the extent that the overall deficiency has **increased** in the period of such trading.

The case is also a salutary tale for liquidators, particularly in circumstances where the office-holder has been involved in advising the directors in the period prior to formal insolvency. Wrongful trading actions are already reasonably uncommon and it is likely that the decision in this case will make them rarer still.

The judge also gives short shrift to the liquidator's attempt to recover the costs of their own time in respect of the investigation into the wrongful trading issues. Having been unsuccessful in their claim for a contribution to the assets of the company, it is somewhat surprising that the liquidators continued to pursue this.

DO: It is so important when companies are being pursued for wrongful trading to ensure that the amount of the calculation of the **increase** in the net deficiency is correct. Even if a business trades beyond the date it should have stopped, an office holder has to prove a further ingredient to make out wrongful trading. He has to show there is an increase in the net deficiency to satisfy the IA requirement for wrongful trading. The 2nd judgement of Snowden J makes it clear that it is not wrongful trading of itself merely to carry on beyond the date when a business should have ceased trading.

Interviewed by David Bowden of David Bowden Law (www.DavidBowdenLaw.com).

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