Refusing a liquidator's wrongful trading application

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Restructuring & Insolvency analysis: David Bowden, solicitor-advocate of David Bowden Law, Andy Whelan, insolvency practitioner and partner at WSM Marks Bloom LLP, and David Oliver, consultant at Verisona Law (who acted for the successful directors), discuss the recent decision in Grant and another v Ralls and others.

Original news

Re Ralls Builders Ltd (in liquidation); Grant and another v Ralls and others [2016] EWHC 1812 (Ch), [2016] All ER (D) 113 (Jul)

The Chancery Division ruled that having found the joint liquidators' application under section 214 of the Insolvency Act 1986 (IA 1986) for a contribution from the directors of a company on a wrongful trading claim had failed, it would not be appropriate to make the director's pay a contribution to the assets of the company in respect of the joint liquidators' fees and expenses in investigating and pursuing that unsuccessful claim.

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 IA 1986, s 214. The amount claimed originally was in excess of £1.13m, 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 up to 31 October 2009, Ralls:

- made trading losses
- suffered from business disruption in the winter months of January and 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 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 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 that 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 25% of the Ralls' parent company (Dylex) by way of acquisition of existing shares for £1.5m and the subscription of £1m for new shares. This £1m was to be injected by Dylex 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
- enable the completion of contracts and maximise recoveries from customers, and
- not worsen, therefore, the position of creditors overall while 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 contribute to Ralls' assets in respect of the diminution of net assets or the losses to unsecured creditors sustained during that period of continued trading. IA 1986, s 214(3) contains a limitation on the circumstances in which a court can make a declaration under IA 1986, s 214(1).

The former directors submitted that 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: In the earlier ruling (*Re Ralls Builders Ltd (in liquidation); Grant and another (Joint Liquidators of Ralls Builders Ltd) v Ralls and others* [2016] EWHC 243 (Ch), [2016] All ER (D) 142 (Feb)), the judge ruled that the involvement of Mr Tickell (a licensed insolvency practitioner) in late July/early August 2010 was highly significant. He said that the approach that 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 1986, s 214 were different:

- IA 1986, s 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
- IA 1986, s 214(3) focused on the regime that the director put in place to protect creditors after the relevant time, rather than the result

Given the express wording in IA 1986, s 214(3) ('every step') it was plain that it 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 to minimise the risk of loss to individual creditors. Otherwise a director could make out the defence under IA 1986, s 214(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 IA 1986, s 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 two days to deal with the following two 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 1986, s 214(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 1986)

What did the judge decide in his July 2016 ruling on contribution to costs and expenses?

DB: By the March 2016 hearing, the joint liquidators had put in a witness statement claiming a contribution to their expenses of just over £256,000 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 ruled that these sums cannot be recovered by way of damages for breach of contract or tort.

Applying *Avrahami v Biran and others* [2013] EWHC 1776 (Ch), [2013] All ER (D) 245 (Jun), 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, Snowden J agrees with Warren J in *Sisu Capital Fund Ltd v Tucker* [2005] EWHC 2321 (Ch), [2005] All ER (D) 351 (Oct) where he said:

'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-[#65533] -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] All ER (D) 229 (Apr) 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?

DB: No. The power under CDDA 1986 is only triggered where a court has made a declaration that a person is liable to contribute to a company's assets under IA 1986, s 214(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 three previous judgments that help Snowden J shape his interpretation of IA 1986, s 214(3):

- *Re Kudos Business Systems*[2011] EWHC 1436 (Ch) (Deputy Judge Sarah Asplin QC)
- *Continental Assurance Co of London PLC*[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 1986, s 214 than in previous cases. He ruled at para [186] (of the February judgment) that:

'...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 judgment. There will be a third 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. While 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 1986, s 214.

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 an IA 1986, s 214 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 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 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. They have to show there is an increase in the net deficiency to satisfy the IA 1986 requirement for wrongful trading. The second judgment 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.

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