

# WHAN CAN WE EXPECT TO GAIN FROM REFORMING THE INSOLVENT TRADING REMEDY?

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*This paper argues that reform of the wrongful trading remedy in s.214 Insolvency Act 1986 is unlikely to yield significant increases in civil recovery for creditors of insolvent companies. The paper argues that the widely held view that procedural restrictions in the provision have unduly limited the application of the wrongful trading rule are without foundation and, likewise, that there is little evidence that current modest levels of litigation under the provision demonstrate underperformance in the sanction relative to the scale of the misconduct against which is directed. The paper, rather, draws on a wide range of analytical and empirical evidence to argue that the scope for application of the sanction is inherently limited by factors independent of the particular rules within the statutory remedy.*

Wrongful Trading - Limited Liability - Cork Report

## INTRODUCTION

The UK Government has proposed significant reforms to the ‘wrongful trading’ remedy in s.214 Insolvency Act 1986 (IA 1986) in order to enhance the amount of financial compensation recovered under the remedy-rule from wrongdoing directors<sup>1</sup>. The proposals have been advanced as part of a package of measures that are intended to enhance ‘transparency and trust’ in UK businesses, but which have a particular focus on expanding civil liability provisions to combat director misconduct<sup>2</sup>. The s. 214 remedy allows a court to impose unlimited personal liability on a director of an insolvent company who is found to have allowed his or her company to continue trading at a time when they knew, or ought to have concluded, that the company could not avoid insolvent liquidation.<sup>3</sup> The

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<sup>1</sup> Small Business, Enterprise and Employment HC Bill (2014-2015) [11] cl. 105 & 106; Department for Business, Innovation and Skills, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Businesses* (July 2013), 11.1-11.12, available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/212079/bis-13-959-transparency-and-trust-enhancing-the-transparency-of-uk-company-ownership-and-increasing-trust-in-uk-business.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212079/bis-13-959-transparency-and-trust-enhancing-the-transparency-of-uk-company-ownership-and-increasing-trust-in-uk-business.pdf) (last viewed 121 July 2013); Department for Business, Innovation and Skills, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Businesses: Government Response* (April 2014), 66 (available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/304297/bis-14-672-transparency-and-trust-consultation-response.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/304297/bis-14-672-transparency-and-trust-consultation-response.pdf)).

<sup>2</sup> Reforms to the wrongful trading rule are accompanied, for example, by proposals to introduce civil compensation in director disqualification proceedings (See Small Business Enterprise and Employment HC Bill, *ibid.*, cl. 98; see also *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Businesses: Government Response*, *ibid.*, 66-67)

<sup>3</sup> Insolvency Act 1986 s.214 (2)(a)-(c).

remedy was introduced in response to a call from the Cork Committee<sup>4</sup> for a “radical extension”<sup>5</sup> in civil liability for directors who increased creditor losses through reckless or negligent trading at a time when their company had little prospect of successful recovery.<sup>6</sup>

The s.214 remedy has long been viewed as a core creditor-regarding rule in UK corporate law. Prentice, for example, described the provision as “unquestionably” one of the most important developments in company law in the last century<sup>7</sup> and the rule is frequently highlighted as an important creditor protection device in the UK<sup>8</sup> and elsewhere.<sup>9</sup> However, the impact of the s.214 remedy has been muted, with successive studies finding few examples of successful recovery under s.214 in the law reports.<sup>10</sup>

Evidence of limited litigation under s.214 has, though, done little to dampen belief in the *potential* of the wrongful trading rule to be an effective remedy. Blame for its poor performance has instead been attributed to restrictive rules within s.214 itself<sup>11</sup>. The fact, for example, that standing to make applications under s.214 is confined to company liquidators<sup>12</sup> has been identified as a key cause of apparent ‘insufficiency of enforcement’<sup>13</sup> of the provision. Similarly, uncertainties surrounding the standard for liability for wrongful trading (i.e. that a director is liable when he or she “knew or ought to have concluded” a company could not avoid insolvent liquidation<sup>14</sup>) as well as difficulties in funding wrongful trading actions linked to the liquidation rule<sup>15</sup>, and even the use of the term ‘wrongful trading’ in describing the s.214 remedy,<sup>16</sup> have all been highlighted as factors that are likely to explain the apparently limited impact of the provision.

The *Transparency and Trust* reforms share this belief in the potential effectiveness of the wrongful trading remedy and seek to ‘unlock’ it by extending the sanction to companies that enter administration, as well as liquidation, and open up new sources of funding for s.214 actions by

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<sup>4</sup> See, *Insolvency Law and Practice: Report of the Review Committee*, (Chairman, Sir Kenneth Cork), Cmnd 8558 (1982) (hereinafter ‘Cork Report’).

<sup>5</sup> Cork Report, *ibid*, 1782.

<sup>6</sup> Cork Report, *ibid*.

<sup>7</sup> D. Prentice, “Creditors Interests and Directors’ Duties” (1990) OJLS 265, 277. See also e.g. P L Davis & S Worthington, *Gower & Davies: Principles of Modern Company Law*, (London: Sweet & Maxwell, 9<sup>th</sup> ed, 2012), . 9-9.

<sup>8</sup> See e.g. Gower & Davies, *ibid*.

<sup>9</sup> See e.g. *Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, Brussels, 21.5.2003, COM (2003) 284 (available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0284:FIN:EN:PDF>, last visited 20 February 2012).

See also *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law*, Brussels, 4 November 2002, at para 4.4 (available at [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf) ( last visited 20 February 2012).

<sup>10</sup> See e.g. L. Sealy, “Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)” in J Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law*, (Oxford: OUP, 1994); R J Mokal, *Corporate Insolvency Law* (Oxford: OUP 2005).

<sup>11</sup> See e.g. A Keay, *Company Directors Responsibilities to Creditors* (London: Routledge-Cavendish, 1997), 125-128.

<sup>12</sup> Insolvency Act 1986, s.214(1).

<sup>13</sup> D. Prentice, “Corporate Personality, Limited Liability and the Protection of Creditors”, in R Grantham and C Rickett (eds) *Corporate Personality in the 20<sup>th</sup> Century*, (Oxford: Hart, 1998).

<sup>14</sup> Insolvency Act 1986 s.214(2)(b). See e.g. F. Oditha “Wrongful Trading” [1990] LMCLQ 205, 207-211

<sup>15</sup> See e.g. Keay, “Company Directors Responsibility to Creditors”, n 11 above, 131-136; Prentice, n 13 above, 123- 125; R J Mokal, *Corporate Insolvency Law*, (Oxford: OUP, 2005), 281-282.

<sup>16</sup> Keay, *ibid.*, 129-130.

granting liquidators a power of sale or assignment over the proceeds of wrongful trading claim<sup>17</sup>. The proposals are, as such, likely to find favour with those who regard s.214 as a fundamentally effective remedy that has been derailed by unfortunate statutory restrictions.

This paper argues, however, that neither the current reforms, nor more far reaching amendments to wrongful trading remedy, are likely to meet the goal of significantly expanding civil recovery under the provision. The paper shows that extending the remedy to companies in administration will only modestly expand the number of cases that fall with section and argues that granting liquidators etc., a power of sale of wrongful trading actions is unlikely to bring the benefits claimed in the *Transparency and Trust* consultation papers. More broadly, however, the paper contends that there is little evidence to support the contention that civil recovery under s.214 has been *significantly* held back by the current statutory rules, such as the liquidation condition. It is argued that the limited impact of the s.214 remedy is more readily attributable to factors independent of those rules and, therefore, that any set of technical reforms are unlikely to bring about a significant increase in civil recovery let alone bring about levels of recovery that would equate to the “radical” expansion of director liability that the Cork Report sought from the remedy. In presenting its analysis, the paper highlights significant gaps in the understanding of the regulatory problem to which the wrongful trading remedy responds, and argues that these gaps result in an exaggerated understanding of the role that any such remedy is likely to play in creditor protection.

The paper is structured as follows. The next part sets out the nature and scope of the wrongful trading remedy, analysing in particular the case presented for the remedy by the Cork Committee, the emphasis that it placed on ‘market failure’ in commercial relationships as creating a pressing need for the rule, and its implicit claims as to the widespread nature of the problem of insolvent, or wrongful trading. In this context, the section discusses the compensatory and deterrent aspects of the wrongful trading rule and argues that the compensation aspect is key to the success of the rule. The next part considers the restrictions placed on the s.214 rule, discussing the particular role that the ‘liquidation rule’ has played in limiting the impact of the remedy, and considering the likely impact of the current reform proposals. The following part presents evidence from a wide range of sources to rebut the claim that statutory restrictions, such as the liquidation rule, are the principle reason for the limited impact of the provision. In particular, the section shows that ‘insolvent trading’ is very rarely identified as a matter of directors’ misconduct in a large sample of director disqualification cases and that comparative evidence from the Australian wrongful trading rule similarly shows that levels of litigation under a wrongful trading rule are little higher where different statutory criteria are adopted. The final substantive section of the paper argues that the wrongful trading remedy, as a creditor protection rule, is subject to inherent limitations in its scope meaning that, whilst useful in some cases, it is most unlikely to bring about a ‘radical’ regime of director liability, however liability rules are structured. The final section presents concluding remarks.

## THE SECTION 214 REMEDY.

### *The Case for a Wrongful Trading Rule.*

The case that the Cork Committee presented for the introduction of the wrongful trading remedy was firmly rooted in concern that limited liability can lead to a certain degree of ‘indifference and lack of concern’ on the part of corporate managers about the level of indebtedness of financially troubled companies<sup>18</sup>. This analysis reflects a common criticism of limited liability, namely, that by allowing

<sup>17</sup> Small Business Enterprise and Employment HC Bill, n 1 above, cl. 105 & 106.

<sup>18</sup> Cork Report, n 4 above, para 1741.

entrepreneurs to cap losses from corporate activity to nominal sums the rule shifts the cost of corporate failure from entrepreneurs to creditors and increases the likelihood that entrepreneurs become indifferent to downside financial risks<sup>19</sup>. This, so the argument goes, can be particularly dangerous when companies encounter difficult financial circumstances because entrepreneurs may feel that they have nothing to lose, but everything to gain, from continuing to trade an insolvent company in the hope that ‘something turns up’.<sup>20</sup> In principle, of course, creditors might be expected to guard against such conduct, either by monitoring entrepreneurs’ conduct for the duration of the credit relationship or by negotiating payments to compensate themselves for increased risk of loss.<sup>21</sup> In practice, however, high monitoring and contracting costs, combined with informational asymmetries, may prevent such effective risk management, which has led many, including the Cork Committee, to conclude that a ‘market failure’ is likely to leave many creditors exposed to an increased likelihood of wrongdoing in limited liability companies.<sup>22</sup>

For Cork the case for a “radical extension”<sup>23</sup> of civil liability for directors who recklessly continued to trade financially troubled companies beyond the point where they had no hope of recovery was clear. Personal liability would remove the protective cloak of limited liability from wrongdoers, allowing creditors to be compensated and acting as a general deterrent of such ‘abuse of limited liability’<sup>24</sup>. The White Paper on reform of insolvency law that followed the Cork Committee’s report,<sup>25</sup> readily accepted this analysis and the need to combat perverse incentives from ‘limited liability’ continues to be cited as the central justification for the rule in s.214.<sup>26</sup>

### *The Structure of the Remedy*

The standard of liability for ‘wrongful trading’ is set out in s.214(2) IA 1986, which provides that the court may impose personal liability on a director of a company that has entered insolvent liquidation where it can be shown that they were responsible for continued trading of a company at a time when they knew “or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation”. A defence is available if a director is able to show that he took “every step with a view to minimising the potential loss to the company’s creditors”<sup>27</sup>.

It is clear, though, that whilst concern about ‘indifference or lack of concern’ amongst directors for corporate liabilities was the trigger for the introduction of the wrongful trading remedy, s.214 is not limited to this particular type of misconduct. The key to liability is to show trading at a time when the company was known to be insolvent, or ought to have been known to be insolvent, and so any such

<sup>19</sup> See e.g. J. Landers, “A Unified Approach to Parent Subsidiary and Affiliate Questions in Bankruptcy” (1975) 42 U. Chi. L.R. 499; M. Jensen & W. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure” (1976) 3 *Journal of Financial Economics* 305

<sup>20</sup> P. Halpern, M. Trebilcock and S. Turnbull, “An Economic Analysis of Limited Liability in Corporation Law”, (1980) 30 U. Toronto L.J. 117, 126 and 140-141.

<sup>21</sup> R. Posner, *The Rights of Creditors of Affiliated Corporations* (1976) 43 U. Chi. L.R. 499.

<sup>22</sup> Cork Report, n 4 above, 1741. See also e.g. Halpern et al, n 19 above, esp., 139-141; J. Freedman, “Limited Liability: Large Company Theory and Small Firms” (2000) 63 MLR 3.

<sup>23</sup> Cork Report, n 4 above, para., 1782.

<sup>24</sup> See generally Cork Report, *ibid*, chapter 43.

<sup>25</sup> *A Revised Framework for Insolvency Law*, Cmnd 9175 (1984)

<sup>26</sup> See e.g. Prentice, “Corporate Personality”, n 13 above at 109-110; A. Keay “Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective”, [1996] *Legal Studies* 431, 434; Davies & Worthington, *Gower & Davies: Principles of Modern Company Law*, n 7 above, para. 9-6. On the market failure rationale for rules such as that in s 214, see also I. Ramsey, “Models of Corporate Regulation: the Mandatory/Enabling Debate”, also in Grantham and Rickett, *Corporate Personality in the 20<sup>th</sup> Century*, 214

<sup>27</sup> Insolvency Act 1986, s.214(3).

‘insolvent’ trading may be caught whether it is borne out of indifference to creditors’ plight or, say, a desire to remove valuable assets from an insolvent company to prevent them falling into the hands of creditors in insolvency proceedings<sup>28</sup> (provided of course that the ‘reasonable prospect’ test is met at the time of the transaction).

In interpreting and applying the statutory criteria for liability, however, the courts have been mindful of the danger of provoking directors to place companies into insolvency proceedings prematurely through too strict an approach to the standard of liability.<sup>29</sup> They have, as such, sought to balance creditor protection with a desire to facilitate reasonable attempts to rescue financially troubled companies through a ‘fact sensitive’ approach that assesses what directors ‘ought to have known’ against the actions of a ‘reasonably prudent businessman’<sup>30</sup> of the relevant type of company<sup>31</sup>. So whilst directors are expected to ensure that they have sufficient financial information to accurately assess the solvency of the company<sup>32</sup>, the courts are keen to recognise that businessmen may not be as ‘cautious as accountants or lawyers’<sup>33</sup> and will avoid assessing directors’ conduct with hindsight<sup>34</sup>. However, where the court finds no basis in fact from which a director could conclude that continued trading was reasonable<sup>35</sup>, liability will be established.

### *The Impact of s.214.*

Studies of the law reports have consistently turned up few examples of s.214 actions. Sealy’s 1994 study of the wrongful trading remedy<sup>36</sup> cited just three fully reported decisions under s.214 and a study by Mokal from 2005<sup>37</sup> found just seven reports of successful applications under the provision. A new study of cases reported up to 30 September 2013<sup>38</sup> by this author found just 16 fully reported decisions under s.214 since 1986,<sup>39</sup> with applications for liability successful in 11 cases and unsuccessful in five cases.<sup>40</sup> In addition, a further 13 cases dealing with procedural questions arising

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<sup>28</sup> See e.g. *Re DKG Contractors Ltd* [1990] BCC 903, discussed further at n 142 below and text thereto.

<sup>29</sup> See e.g. Park J in *Singer v Beckett* [2007] 2 B.C.L.C. 287, [281]

<sup>30</sup> *Re Brian D Pierson Ltd* [1999] BCC 26, 52.

<sup>31</sup> See generally *Gore-Browne on Companies*, A. Alcock (ed) (Bristol, ), 61[21C].

<sup>32</sup> *Re Produce Marketing Consortium Ltd* [1989] BCLC 520; *Re DKG Contractors Ltd* [1990] BCC 903.

<sup>33</sup> *Re Brian D Pierson Ltd* [1999] BCC 26, 52.

<sup>34</sup> *Re Sherborne Associates Ltd* [1995] BCC 40,54; *Re Brian D Pierson Ltd*, *ibid*, 49.

<sup>35</sup> See e.g. *Re Brian D Pierson Ltd*, *ibid*.

<sup>36</sup> Sealy, n 10 above.

<sup>37</sup> Mokal, n 15 above, 289.

<sup>38</sup> The study was conducted through a search of the Westlaw database of cases. Two search protocols were run in the database. The terms of the first search were “Insolvency Act 1986” + “section 214” in the advanced search function. The second search was for all references to “wrongful trading” or “insolvent trading” in the ‘subject/keyword’ box. Full case reports of all ‘hits’ from these searches were then examined to determine whether the cases dealt with a substantive or procedural issue relevant to s.214 proceedings. Equivalent searches were carried out using ‘Lexis Law Library’ and ‘BAILII’ on-line data bases for further coverage of reported cases.

<sup>39</sup> *Re Bangla Television Ltd* [2009] EWHC 1632 (Ch); *Re Brian D Pierson (Contractors) Ltd* [1999] BCC 26; *Re DKG Contractors Ltd* [1990] BCC 903; *Re Idessa Ltd* [2011] EWHC 804 (Ch); *Re Kudos Business Solutions Ltd* [2011] EWHC 1436; *Official Receiver v Doshi* [2001] 2 BCLC 235; *Re Produce Marketing Consortium* (1989) 5 BCC 569; *Re Purpoint Ltd* [1991] BCC 121; *Roberts v Frohlich* [2011] EWHC 257 (Ch); *Rubin v Gunner* [2004] EWHC 315 (Ch); *Singla v Hedman* [2010] EWHC 902 (Ch); *Re Hawkes Hill Publishing Co Ltd* [2007] BCC 937; *Re Langreen Ltd* (unreported); *Liquidator of Marini Ltd v Dickenson* [2003] EWHC 334(Ch); *Re Sherborne Associates Ltd* [1995] BCC 40; *Re Continental Assurance Company of London plc* [2007] 2 BCLC 287.

<sup>40</sup> *Re Hawkes Hill Publishing Co Ltd*; *Re Langreen Ltd*; *Liquidator of Marini Ltd v Dickenson*; *Re Sherborne Associates Ltd*; *Singler v Beckett* (above).

from a s.214 application, but not determining the substantive question of liability, were reported.<sup>41</sup> Up-to date analysis therefore documents just 29 reported applications under s.214 between 1986 and 2013 with liability being imposed in only 11. Further, levels of litigation under s.214 appear to be markedly lower than is the case with other provisions of the Insolvency Act concerning director misconduct. Analysis of legal databases using equivalent search criteria and methodological analysis revealed, for example, over 60 reports relating to liquidator claims of *director* liability for misfeasance or breach of duty initiated under s.212 IA 1986. Further, there were over 80 case reports between 1986-2013 concerning actions by liquidators in respect of ‘transactions at an undervalue’ under s.238 IA 1986<sup>42</sup> and over 50 reports of proceedings concerning transactions at a preference contrary to s.239. Of course, actions under ss.238 & 239 IA 1986 are not limited to wrongdoing directors and may be brought against any person dealing with the company in respect of the impugned transaction<sup>43</sup>. Nonetheless, both provisions are concerned with wrongdoing, typically by directors, in the financial twilight zone, and so have clear value as comparators of levels of litigation under s.214. By way of further comparison, around 1,500 directors of insolvent companies are disqualified annually for ‘unfitness to be concerned in the management of companies’,<sup>44</sup> with several hundred disqualification cases appearing in the law reports since 1986.

Of course, not every wrongful trading action, successful or otherwise, will make it to the law reports and to this end, it has been suggested that the reported cases may under-represent use of the remedy in so much as liquidators are successful in using the *threat* of litigation under s.214 to obtain a settlement from directors without the need for formal litigation<sup>45</sup>. However, no detailed empirical evidence has been offered to support this claim<sup>46</sup>, still less has any evidence been offered to suggest that directors are more likely to settle a claim for wrongful trading than they are any other personal claim against them, such as claims for misfeasance or breach of duty under s.212 IA 1986, or a claim relating to a transaction at a preference or undervalue. So whilst, obviously, some wrongful trading cases will be settled without formal litigation, there is no reason to suppose that settlements have a disproportionate impact on the reporting of wrongful trading cases. Indeed, as Cheffins points out, successful settlement of s.214 claims would be unlikely without a credible threat of litigation, and the low number of reported cases does not readily support liquidators in making such a threat<sup>47</sup>.

### *The Objectives of the Rule: Compensation and Deterrence.*

Low levels of litigation under s.214 suggest that the sanction has delivered little to creditors by way of direct compensation for wrongful trading. More than this though, it also raises a question over the

<sup>41</sup> *Andrew Rhodes Ltd v Andrew Rhodes* [2005] EWHC 1005 (Ch); *Burgoine v Waltham Forest LBC* [1997] BCC 347; *Choen v Davies* (sub nom *Re International Championship Management Ltd*) [2006] EWHC 768 (Ch); *Re a Company ex p Copp* (1988) 4 BCC 424; *Re Farmizer (Products) Ltd* [1997] BCC 655; *Hi-Tech Profiles Ltd v Brown* [2005] EWHC 3500 (Ch); *Re Howard Holdings Inc* [1998] BCC 549; *Re Hydrodan (Corby) Ltd* [1994] BCC 161; *Lewis v Inland Revenue Commissioners* [2001] 3 All ER 499; *Liquidator of Wendy Fair Ltd v Hobday* [2006] EWHC 5803 (Ch); *Re Oasis Merchandising Services Ltd* [1998] Ch. 170; *Phillips v McGregor-Paterson* [2009] EWHC 2385 (Ch).

<sup>42</sup> Search protocols were the same as set out in n 38, above, save for changing the relevant statutory provisions and ‘subject/keywords’.

<sup>43</sup> Insolvency Act 1986, s 241(2).

<sup>44</sup> Insolvency Service: *Annual Report and Accounts 2011-2012* (London, 2012), table 16.

<sup>45</sup> See e.g. A. Hicks, “Wrongful Trading – has it been a failure?” (1993) 8 *Insolvency Law and Practice* 134; V. Finch, “Directors Duties: Insolvency and the Unsecured Creditor” in A. Clarke (ed), *Current Issues in Insolvency Law* (London: Wildy’s, 1991), 97.

<sup>46</sup> Hicks’ (*ibid*), for example, basis his contention on the results of an informal survey of solicitors and insolvency practitioners but offers no detailed breakdown of the results of the study.

<sup>47</sup> B. Cheffins, *Company Law: Theory, Structure and Operation*, (Oxford: OUP, 1997), 545.

extent to which the rule can be regarded as having a beneficial deterrent impact on insolvent trading. The compensatory and deterrence aspects of the wrongful trading rule were both integral to Cork's idea of how civil liability would align the welfare goals of entrepreneurs and corporate creditors and so correct the 'market failure' in corporate credit relationships that Cork identified as creating the need for the rule<sup>48</sup>. Compensation awards to creditors would remedy established instances of (past) misconduct and the possibility of liability would make it clear to directors that limited liability will not insulate them from the costs of insolvent trading, thereby neutralising any perverse effect the rule may have and ensuring that directors, like creditors, have a clear interest in the sound management of corporate assets in times of financial distress. To put it in other words, compensation would remedy actual instances of 'market failure' and the deterrent effect of the rule would help prevent market failure from occurring (but where it did, compensation may be applied).

Thus, although liability for wrongful trading is *ex post* in its nature (i.e. compensation can only be ordered in insolvency proceedings after wrongful trading has taken place), Cork saw the rule as bringing clear *ex ante* benefits in encouraging greater care of the assets of financial troubled companies<sup>49</sup>. Indeed, the Cork Report went to so far as to claim that the possibility of *ex post* liability for wrongful trading would "encourage directors to satisfy themselves that their companies were adequately capitalised"<sup>50</sup> from the very outset of trading.

The extent to which s.214 can be expected to act as such an effective deterrent of wrongful trading is, however, unclear. Despite occasional claims that s.214 has a powerful deterrent effect on insolvent trading<sup>51</sup>, no detailed evidence as to the deterrent effect of the sanction has, to the author's knowledge, been presented<sup>52</sup>, and its deterrent impact has been widely doubted<sup>53</sup>. Uncertainty surrounding the standard for liability under s.214, that is, when a director will be deemed to 'ought to have known' that a company had no *reasonable* prospect of avoiding liquidation is, for one thing, not likely to aid the deterrent effect of the rule. Effective deterrence, beyond the vague notion that one should not 'trade when insolvent', surely rests on a director being able to predict, with a good degree of certainty, when liability is likely to arise (and so when to cease trading). The fact that the statutory trigger for liability is clouded in uncertainty, though understandable if reasonable rescue attempts are not to be precluded<sup>54</sup>, must therefore impair the deterrent effect of the rule<sup>55</sup>. This is all the more so because misunderstanding of the nature of liability rules and confusion and about the risks of being punished for non-compliance place inherent limitations on the deterrent impact of personal liability rules<sup>56</sup>.

More generally, it is unclear that personal liability rules, such as s.214, are effective in motivating directors' conduct in the manner that Cork and others have assumed. A study by Baldwin<sup>57</sup>, for example, suggests that personal liability rules do not act as effective deterrents to directorial

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<sup>48</sup> See n 22 above, and text thereto.

<sup>49</sup> See generally, Cork Report n 4 above, 1783-1784.

<sup>50</sup> Cork Report, *ibid.*, above, 1785.

<sup>51</sup> See e.g. Hicks, A. Hicks, "Wrongful Trading – has it been a failure?" n 45 above, 135

<sup>52</sup> *Ibid.*

<sup>53</sup> See e.g. V Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2nd ed, 2009), 749.

<sup>54</sup> See e.g. *Re Brian D Pierson Ltd* [1999] BCC 26, 52; *Re DKG Contractors Ltd* [1990] BCC 903 and generally text to nn 29-35 above.

<sup>55</sup> See e.g. Oditah, n 14 above.

<sup>56</sup> See general, R Baldwin, M Cave & M Lodge, *Understanding Regulation: Theory Strategy and Practice* (Oxford: OUP, 2<sup>nd</sup> ed, 2012), 239-243. See also J Freedman, "Limited Liability: Large Company Theory and Small Firms" (2000) 63 MLR 317, 344.

<sup>57</sup> R. Baldwin, "The New Punitive Regulation" (2004) 67 MLR 351.

misconduct. As part of an inquiry into the response of directors of FTSE companies to punitive regulation, Baldwin studied the main ‘drivers’ behind directors’ efforts to manage regulatory risks. He found that ‘corporate’, as opposed to ‘personal’, concerns were the most important factors motivating compliance with regulatory standards. Some 90% of the directors questioned as part of Baldwin’s research cited ‘concern for their company’s reputation’ as an important driver of their conduct, with many fewer citing ‘personal sanctions’ as the most important driver of their conduct.<sup>58</sup>

But even setting aside doubts about the general effectiveness of civil liability rules in deterring director misconduct, the deterrent effect of wrongful trading rule is likely to be significantly weakened by the low number of wrongful trading cases. Cheffins has noted that effective deterrence of wrongful trading through the provision of civil liability rests on active enforcement of the legislation<sup>59</sup>, and for good reason. Perverse incentives from limited liability will surely only be effectively countered if directors feel that there is a strong prospect of civil recovery being imposed for wrongful trading. The fewer instances of actual recovery there are, therefore, the less likely we could expect the possibility of civil liability to be in countering errant behaviour. Of course, this is not to say that the wrongful trading rule will have no deterrent effect. The existence of the rule may well influence directors’ behaviour simply because of its setting an expected norm of behaviour. But if liability does not seem likely then directors may still feel that they have ‘much to gain, and nothing to lose’ from insolvent trading, in spite of the existence of the remedy.

Indeed, it is notable in this respect that the *Transparency and Trust* papers focused squarely on enhancing the *compensatory* aspect of the wrongful trading remedy as the means to ‘better protect creditors’ and made little or no direct reference to enhancing the *deterrent* aspect of the sanction as driver of reform<sup>60</sup>. It would, of course, probably be wrong to conclude from this that the Government saw little or no deterrent benefit from the sanction, but it does illustrate still further the degree to which effective deterrence of wrongful trading is seen as dependant upon the compensatory aspect of the remedy.

## THE ‘LIQUIDATION’ RULE

A key feature of s.214 that has been blamed for restricting the impact of the remedy is the rule limiting standing to bring a claim for wrongful trading to liquidators of companies that have entered insolvent liquidation. There are two aspects to the liquidation rule that have been seen as limiting the scope of the sanction, both of which the current reform proposals seek to address.

### *The Scope of the Wrongful Trading Rule*

Most straight-forwardly, the simple restriction of the remedy to companies that have entered *insolvent liquidation*,<sup>61</sup> that is companies that enter liquidation at a time when their assets are insufficient to discharge their liabilities, including the expenses of winding up<sup>62</sup>, means that the remedy is unavailable in the case of companies that enter other forms of insolvency proceedings, such as

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<sup>58</sup> *Ibid*, 368.

<sup>59</sup> Cheffins, n 47 above. On the importance of likelihood of sanction on the deterrent effect of regulatory rules, see also Baldwin *et al*, *Understanding Regulation*, n 54 above.

<sup>60</sup> Department for Business, Innovation and Skills, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Businesses*, n 1 above and Department for Business, Innovation and Skills, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Businesses: Government Response* also at n 1, above.

<sup>61</sup> This is affirmed in s.214(2)(a), which states explicitly that the provision only applies to companies that have entered insolvent liquidation.

<sup>62</sup> Insolvency Act 1986, s.214(6).

administration, or no insolvency proceedings at all. The liquidation restriction was not part of the Cork Committee proposals for the wrongful trading rule, which recommended simply that an action for wrongful trading should be available to any liquidator, administrator or creditor of a company where trading was found to have taken place at a time when the director knew, or ought reasonably to have known, that the company was insolvent on a cash flow basis.<sup>63</sup>

The Government of the day, however, concluded that such a broad power of civil recovery would have the effect of deterring genuine entrepreneurs from operating businesses<sup>64</sup> and, as a result took the decision to restrict wrongful trading liability to directors of companies that entered insolvent *liquidation*. Limiting wrongful trading liability to winding-up cases in this way was seen to strike a better balance between the respective rights of creditors and entrepreneurs. No evidence as to the advantage of the more restricted rule was, however, presented by the Government and subsequent developments in directors' duties rules rather suggest that concerns about a broader liability rule deterring entrepreneurs were, at best, exaggerated. The decision in *Liquidator of West Mercia Safetywear v Dodd*<sup>65</sup> that the 'interests of the company' become identified with the interests of the companies' creditors where insolvency is very likely, has instituted potential directorial liability for insolvent trading<sup>66</sup> that is not tied to formal insolvency proceedings and few, if any, commentators have suggested that this rule has deterred entrepreneurs from incorporating. So it is no surprise that liquidation rule has come to be regarded as an unnecessary restriction on the s.214 remedy and a significant contributing factor to low levels of litigation under the provision<sup>67</sup>.

In direct response to these concerns the current reforms seek to extend the wrongful trading remedy to companies that enter insolvent *administration*, as well as insolvent liquidation<sup>68</sup>. However, it seems unlikely that this modest extension of wrongful trading liability will have a dramatic impact on the number of cases brought under the provision. In 2012, for example, over 16,000<sup>69</sup> companies were recorded as entering liquidation proceedings in England and Wales, of which the vast majority are likely to be insolvent liquidation proceedings. During the same period, however, just 2,500 companies entered administration. The total number of companies entering administration therefore represented less than 20% of the number of liquidations. Extending the wrongful trading remedy still further to other forms of insolvency proceeding, in addition to administration, would also seem unlikely to result in a significant rise in cases. In 2012, for example, just 1,222 companies in England and Wales were recorded as entering receivership proceedings<sup>70</sup>, and just 839 companies were recorded as undertaking company voluntary arrangements. So, whilst extending the wrongful trading remedy to

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<sup>63</sup> Cork Report, n 4 above, para 1086.

<sup>64</sup> *A Revised Framework for Insolvency Law*, Cmnd 9175 (1984), at para 52.

<sup>65</sup> [1998] BCLC 250.

<sup>66</sup> See e.g. *Re DKG Contractors Ltd* [1990] BCC 903, discussed further below. See further discussion of Finch, *Corporate Insolvency Law*, n 53 above, at 688-692.

<sup>67</sup> See e.g. Prentice, n 7 above; Keay n 11 above; and Finch n 53 above, at 749.

<sup>68</sup> Small Business, Enterprise and Employment HC Bill, n 1 above, cl. 105 (proposing the insertion of a new s. 246ZB into the Insolvency Act 1986). The new provision s.246ZB ("Wrongful Trading: Companies in Administration") mirrors s.214 ("Wrongful Trading") exactly in setting the standard for liability and defences etc., save, some minor variations in language and, of course, that the new section refers to 'administration' and 'administrators' in place of 'liquidation' and 'liquidators'.

<sup>69</sup> *Insolvency Service, Company liquidation in England and Wales 1960 to present*, available at <http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm> (last accessed Feb 2014)

<sup>70</sup> *Insolvency Service, Receiverships, administrations and company voluntary arrangements in England and Wales, 1987 to present*, available at <http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm> (last accessed Feb 2014)

administration might be expected to produce some expansion in civil recovery, the upswing is not likely to be transformative. And this is especially so when it is borne in mind that some companies that enter administration will go on to enter liquidation proceedings and so account for a portion of current s.214 cases.

Of course, it might be argued that extending the wrongful trading remedy to companies that enter administration could nonetheless bring about beneficial increases in the deterrent effect of the sanction, in so much as it encouraged greater care of corporate assets in circumstances where insolvent *administration* is likely, and not just insolvent liquidation. This could be particularly significant in so much as the assets of companies that enter administration proceedings may be greater than the assets those that enter liquidation. However, it seems unlikely that significant new gains in terms of preserving corporate assets will be made by the new rules. For one thing, the deterrent effect of the reformed wrongful trading remedy, whether in liquidation or administration cases, is still likely to be limited by a low likelihood of sanction. For another, it is doubtful whether the new rules would in fact break significant new ground in terms of deterrence. From the standpoint of the average director, the deterrent effect of the existing rule in s.214, such as it is, will surely come into play as soon as the solvency of their company is in serious and long-term doubt such that it looks likely that insolvency proceedings are inevitable. It would be a brave, or more likely foolhardy, director who in full knowledge of the s.214 rule concluded that even though the solvency of their company was in long-term doubt such that there was ‘no reasonable prospect’ of avoiding insolvency proceedings, they did not need to worry about ‘wrongful trading’ liability because they were sure that their company would only enter insolvent administration, not liquidation. Of course few, if any directors, could be so confident – compulsory winding up following a creditors’ petition is always a possibility in an ‘insolvent’ company<sup>71</sup>. So my argument here is that the trigger for the deterrent effect the existing s.214 rule is surely the onset of serious financial distress such that some insolvency proceeding looks inevitable. It is not foresight of the particular *type* of insolvency proceeding that the company eventually enters, which is not something that is wholly within the directors’ power to determine in any case. Further, it is also worth noting that potential director liability for insolvent trading before administration is not, in any case, entirely without precedent in English law. The line of authority that has grown up under the *West Mercia*<sup>72</sup> case, provides an existing possibility for an action by or on behalf of the company<sup>73</sup> against a director who breaches their duty to take account of ‘creditor interests’ in the pre-insolvency context, whether that company ends up in liquidation<sup>74</sup>, administration<sup>75</sup> (or indeed no insolvency proceedings at all). So, whilst extending wrongful trading liability to administration cases may create *some* scope for additional *recovery* in cases where previously there was none, it seems unlikely that it will extend the deterrent effect of liability far beyond that of the existing rule in s.214 and the principle in the *West Mercia* case.

#### *Funding Wrongful Trading Claims.*

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<sup>71</sup> Insolvency Act 1986, s. 122(1)(f) (company ‘unable to pay its debts’) and s. 123 (‘definition of inability to pay debts’)

<sup>72</sup> [1998] BCLC 250

<sup>73</sup> In the context of administration, see Insolvency Act 1986, Schedule 1, para 5 (administrators power to bring or defend any action or other legal proceedings in the name and on behalf of the company).

<sup>74</sup> E.g. *Re DKG Contractors Ltd* [1990] BCC 903.

<sup>75</sup> See e.g. *Facia Footware Ltd (in administration) v Hinchliffe* [1998] 1 BCLC 218 for a claim made by a liquidator in respect of a directors’ breach of the modified duty to have regard to the interests of creditors in promoting the interests of the company.

Aside from simply limiting the availability of wrongful trading proceedings, it is also claimed that the ‘liquidation rule’ in s.214 has played a strong part in restricting funding for wrongful trading actions, and so again is likely to have unduly limited the impact of the remedy.<sup>76</sup> An application for civil recovery against a director for wrongful trading must, under s.214(1) be made by a liquidator for the benefit of the creditors of an insolvent company *pari passu*. The costs of litigation under s.214 are, as such, recoverable from the insolvent company’s estate as part of the expenses that the liquidator incurs in the proper execution of their duties<sup>77</sup>. There is a clear risk, however, that the assets of the insolvent company will not be sufficient to meet the costs of litigation and so it is possible that without a successful order for costs a liquidator could end up personally liable for some or all of the costs of litigation. Liquidators will therefore be unlikely to commence proceedings under s.214 unless they feel that there is a high chance of successful recovery. Some assistance in this regard was intended to be provided by the rule in s.176ZA IA 1986, inserted by the Companies Act 2006<sup>78</sup>, which gives the expenses of winding up priority over a floating charge where the assets of the company are otherwise insufficient to meet them. However, priority over a floating charge does not *guarantee* that liquidators will be able to cover their costs, as the rule is of little assistance where the assets of the company (including floating charge assets), are in any case insufficient to cover potential litigation costs and other expenses of the winding up.

Creditor-funding of wrongful trading actions has long been canvassed as a potential way around the funding problems that liquidators may encounter in s.214 cases. However, creditors have no direct right of application under the current version of s.214 and so could only fund litigation by indemnifying the liquidator. The likelihood of creditors agreeing to underwrite a wrongful trading application under the current law was, however, restricted by the decision of the Court of Appeal in *Re Oasis Merchandising Services Ltd*<sup>79</sup> which held that rights to recovery under s.214 were not the ‘property’ of the company subject to the liquidator’s power of sale under the Insolvency Act<sup>80</sup> (as the right to damages arose only after litigation). A significant free-rider problem therefore exists under current arrangements for any creditor who wishes to underwrite a s.214 application, as any sums recovered must be available to repay all creditors *pari passu*, not just those covering the costs of liquidation. This problem could be overcome, of course, if the creditors were given ‘private’ rights of recovery in respect of wrongful trading outside the liquidation process, as, in fact, the Cork Committee originally proposed<sup>81</sup>. However, this would take recovery outside of the *pari passu* principle, which is the reason that was given for limiting the right to recover to liquidators of insolvent companies during Parliamentary consideration of the s.214 remedy<sup>82</sup>.

#### *Assignment and Sale of Wrongful Trading Actions.*

The current reforms seek to relieve these funding problems by removing the *Oasis Mechanising* rule and giving liquidators (or administrators) a statutory right to assign a wrongful trading action<sup>83</sup>. *Prima*

<sup>76</sup> See e.g. Keay, “Company Directors Responsibility to Creditors”; Prentice, “Corporate Personality; Mokai, *Corporate Insolvency Law*, at n 14 above.

<sup>77</sup> Insolvency Rules 1986 (SI 1986/1925), r. 4.218(1), (as amended by Insolvency (Amendment) Rules 2008 (SI 2008/737). See further Finch, *Corporate Insolvency Law*, n 52 above, 555.

<sup>78</sup> Companies Act 2006, s.1282(1).

<sup>79</sup> [1997] BCC 282.

<sup>80</sup> Insolvency Act 1986, sched. 4, para 6. See further Finch, *Corporate Insolvency Law*, n 52 above, 557-559.

<sup>81</sup> Cork Report, n 4 above, para 1086.

<sup>82</sup> HL Deb. vol. 461 coll. 743-744 (21 March 1985).

<sup>83</sup> Small Business, Enterprise and Employment HC Bill, n 1 above, cl. 106, proposing the insertion of a new s.246ZD into the Insolvency Act 1986 granting liquidators or administrators a power of assignment over causes of action for wrongful trading (as well as any causes under other provisions of the Insolvency Act 1986, such as

*facie*, creditor funding of wrongful trading actions through this new power could increase levels of litigation under the remedy, though, of course, the principle benefit of that litigation would be derived by those creditors who took the benefit of the action from the liquidator (or administrator). Nonetheless, the *Transparency and Trust* consultation paper envisaged that the introduction of a power of assignment would lead to the development of a ‘market’ for wrongful trading actions<sup>84</sup>, and so benefit the general body of unsecured creditors to the extent that the proceeds of an assignment would increase the assets of insolvent company, and hence the dividend paid by liquidator<sup>85</sup>. However, the extent to which the general body of creditors would in fact benefit under the proposed new rules is uncertain and BIS’s own impact assessment of the changes, published at the time the *Small Business, Enterprise and Regulation Bill*<sup>86</sup> was introduced to Parliament, described the number of additional claims that could be expected as “unknown” but likely to be “relatively low”<sup>87</sup>. Creditors are only likely to pay for assignment of rights of action for wrongful trading where the prospects of recovery against an errant director are high, that is, where the director concerned has sufficient assets to be able to satisfy a judgement against them *and* in cases where there is a high chance of recovery i.e. where it appears that there is a strong chance the elements of liability could be made out in litigation. Any market that developed in wrongful trading claims is therefore likely to concentrate on high-value claims; no creditor is likely to pay for a worthless or speculative claim, or at least, they would not pay very much for them.

However, it is precisely these ‘high-end’ claims that are most likely to be pursued by liquidators themselves, so it may be the case that the development of a market for rights of action for wrongful trading claims will be hampered by liquidators being unwilling to sell the claims that creditors are most interested in buying. Of course, some liquidators may prefer to sell high-value claims to avoid the expense and delay that litigation entails, essentially preferring ‘the bird in hand’ of the creditor’s offer and a quicker dividend for the general body of creditors. Assuming that some liquidators would be willing to sell on this basis, however, the sale would likely have to be at a significant discount to the expected proceeds of recovery in order to incentivise the creditor to make the purchase. The general body of creditors may therefore end up worse off under the new rules if, as seem likely, they simply resulted in liquidators selling high-value claims at a discount to the ‘price’ in director liability that could be achieved if the liquidator litigated himself.

Of course, it could be argued that the increased possibility of litigation from the change could enhance the deterrent effect of the wrongful trading rule, benefitting corporate creditors through reduced incidences of wrongful trading. Enhancing the deterrent aspect of the rule was not specifically highlighted as a motivation for change, but the *Transparency and Trust* consultation paper discussion paper did comment that new powers of assignment would, by enhancing the likelihood of litigation for wrongful trading, encourage directors to settle wrongful trading claims, thereby increasing the flow of funds to creditors. The extent to which either of these things would occur, though, is difficult to gauge and the consultation paper offered no detailed evidence to substantiate its claim about

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causes of action for fraudulent trading and those held under ss. 238 and 239 of the Act).

<sup>84</sup> ‘*Transparency and Trust*’, n 1 above, paras 57 & 11.8

<sup>85</sup> *Ibid*, para 11.8.

<sup>86</sup> Note 1, above.

<sup>87</sup> Small Business, Enterprise and Employment Bill: enabling liquidators impact assessment (BIS 14/931), 8, (available at

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/322337/Enabling\\_Liquidators\\_and\\_Administrators\\_to\\_assign\\_to\\_third\\_parties\\_certain\\_rights\\_of\\_action\\_that\\_only\\_they\\_can\\_bring\\_under\\_the\\_Insolvency\\_Act\\_1986.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/322337/Enabling_Liquidators_and_Administrators_to_assign_to_third_parties_certain_rights_of_action_that_only_they_can_bring_under_the_Insolvency_Act_1986.pdf)

settlement of actions. But given doubts over the general deterrent impact of the remedy because of low levels of recovery and the fact that significant upswing in recovery from the new rules seems unlikely, there is little basis on which to conclude that the new powers would significantly enhance the deterrent impact of the rule or substantially increase settlements.

#### THE IMPACT OF RESTRICTIONS IN S.214

The current reform proposals are therefore unlikely to meet the goal of bringing about a significant increase in financial compensation for creditor victims of wrongful trading, and nor, for that matter, are they likely to significantly enhance the deterrent effect of the wrongful trading rule. But what is nonetheless clear is that the reforms are predicated on the belief that substantial scope exists for expanding civil recovery for wrongful trading. This, of course, is unsurprising given the widespread belief that the s.214 remedy has underperformed *relative to the incidence of wrongful trading* because of restrictions in remedy itself. In fact, however, there is no clear evidence to bear out this assumption. Indeed, the evidence rather suggests that opportunities for expanding civil recovery for wrongful trading are inherently limited, regardless of the particular rules in s.214.

##### *Reforms to funding in s.176ZA IA 1986.*

The claim that ‘statutory’ restrictions, such as the ‘liquidation rule’, have severely inhibited litigation under s.214 is dealt a blow by the failure of reforms in s176ZA IA 1986 to have any noticeable impact on levels of litigation under the provision. The introduction of s 176ZA (granting liquidators’ expenses priority over floating charge-holders) was canvassed, as stated above, as a measure that was likely to ease funding problems with liquidator litigation. As such, the rule could have been expected to have resulted in an increased number of s.214 applications if, as has often been claimed, difficulties faced by liquidators in funding s.214 litigation have inhibited use of the sanction. However, according to the author’s study of reported s.214 cases<sup>88</sup>, just five substantive cases determining liability under s.214 were reported in the five-year period after s.176ZA was brought fully into force in 2008<sup>89</sup>, with no cases<sup>90</sup> reported between January 2012 and June 2013.

##### *B. Directors’ Disqualification and Insolvent Trading.*

Further evidence that statutory restrictions have only a marginal impact on litigation under s.214 can be seen in the absence of a significant number of instances of ‘insolvent trading’ identified in director disqualification proceedings under ss.6&8 Company Directors Disqualification Act 1986.

Insolvent trading to the detriment of creditors is as a paradigm example of conduct that can make a director ‘unfit to be concerned in the management of companies’ under s.6 or s.8 of the Company Directors Disqualification Act 1986 (CDDA)<sup>91</sup>. The essence of the misconduct that is sanctioned in disqualification is the same as under s.214 IA 1986, namely that a director allows his or her company to continue trading at a time when it was insolvent and unlikely to be able to pay its debts. However,

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<sup>88</sup> See **n 41** above and text thereto.

<sup>89</sup> The Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order, (SI 2007/3495), arts 2(3); 3(1)(v).

<sup>90</sup> The only significant case reported during the period was *Re Integral Ltd* [2013] EWHC 164. The case concerned an application for an administration order which was refused by the court in favour of making a winding up order, the order for winding up was made in part because of the possibility of proceedings for wrongful trading in liquidation proceedings.

<sup>91</sup> On Insolvent trading on disqualification for unfitness cases, see generally A. Walters and M. Davis-White, “Directors’ Disqualification and Insolvency Restrictions”, (London: Sweet & Maxwell, 3<sup>rd</sup> ed, 2010), 5-05 to 5-26.

it has been repeatedly affirmed that conduct that does not amount to wrongful trading under s.214 IA 1986 may nonetheless be held to constitute unfit conduct under the disqualification rules<sup>92</sup>. Disqualification looks at a director's conduct in the round in order to decide whether the conduct is unfit,<sup>93</sup> and the stress is very much placed on showing that continued trading exposes creditors to unreasonable risk<sup>94</sup>. It is not, as such, necessary to make out specific matters such as showing that a company had no reasonable prospect of avoiding *insolvent liquidation* in disqualification cases, in contrast to s.214.

In addition to a more flexible standard for liability, other inhibiting rules in s.214 are absent or much reduced in disqualification cases. Disqualification proceedings under s 6 of the CDDA may, for example, arise in respect of the conduct of directors of any insolvent company<sup>95</sup>, not just those that enter insolvent *liquidation*.<sup>96</sup> Further, disqualification proceedings are public interest<sup>97</sup> regulatory proceedings, conducted by the Secretary of State (or the Official Receiver on his behalf)<sup>98</sup> under the umbrella of the Insolvency Service division of the Department of Business, Innovation and Skills. The objective of disqualification is not therefore to secure compensation for creditors, but simply to fulfil the public interest in ensuring that individuals who are unfit to manage companies should be prevented from doing so, at least for the duration of their disqualification. So whilst standing to make an application for disqualification is limited to the Secretary of State<sup>99</sup>, or in the case of s.6, the official receiver acting on his behalf<sup>100</sup>, disqualification proceedings are not inhibited by the sort of cost issues that may affect civil recovery by the liquidator under s.214. The cost of disqualification litigation is paid by the state and not by individual insolvency practitioners as part of their expenses. Director disqualification cases therefore provide a good source of data from which to gauge the size of the pool of cases in which civil recovery for insolvent trading might be available for creditors, and therefore the impact of procedural rules on levels of recovery under s.214.

Between 2007 -2012 the Insolvency Service published details of the matters of 'unfit conduct' cited in concluded disqualification proceedings under ss.6 and 8 of the CDDA. This data shows that insolvent trading is rarely cited in successful disqualification cases. In 2010-2011, for example, the Insolvency Service figures show that 'trading at a time when a company is knowingly or unknowingly insolvent' was cited as matter of unfit conduct in just 35 (or 1.94%) of the 1,800 disqualification cases concluded during the year<sup>101</sup>. Indeed, as fig. 1 shows, insolvent trading has been infrequently cited in disqualification cases for each of the years in which the Insolvency Service has published a breakdown of unfit conduct allegations, with just 162 instances of insolvent trading recorded in over 7,900 disqualification cases concluded between 2007 and 2012.

<sup>92</sup> *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch. 164, p 183; *Re Bath Glass Ltd*, [1988] 4 BCC 130, 133; *Re Synthetic Technology Ltd* [1993] BCC 549, 562.

<sup>93</sup> See e.g. Peter Gibson J in *Re Bath Glass Ltd* [1988] 4 BCC 130, 133-134.

<sup>94</sup> Walters and Davis-White, n 91 above, para 5-11, after Lewison J in *Re Mea Corporation* [2006] EWHC 1846; [2007] BCC 288, [108]

<sup>95</sup> Company Directors Disqualification Act 1986, s 6(1).

<sup>96</sup> See Company Directors Disqualification Act 1986, s6(1); Companies (Reports on Conduct of Directors) Rules 1996 (SI 1996/1909), as amended. See further, R. Williams, *Disqualification Undertakings, Law Policy & Practice*, (Bristol: Jordan Publishing, 2011), 79-81

<sup>97</sup> Company Directors Disqualification Act 1986, s 7(1) & s 8 (1). On the public interest element of disqualification proceedings see further Walters and Davis-White, n 91 above, paras. 2.23-2.36

<sup>98</sup> Company Directors Disqualification Act 1986, s 7(1).

<sup>99</sup> Company Directors Disqualification Act 1986, s.7(1) & s.8(1).

<sup>100</sup> Company Directors Disqualification Act 1986, s 7(1).

<sup>101</sup> Insolvency Service, *Insolvency Service Annual Report and Accounts 2011- 2012*, (London, 2012), table 16. Available at <http://www.bis.gov.uk/assets/insolvency/docs/publication-pdfs/ar2011-2012.pdf>, last viewed 19 July 2013.

**Figure 1. Cases Concluded under Section 6 - 8 of the Company directors Disqualification Act 1986 citing ‘Trading at a time when company knowingly or unknowingly insolvent’ and other ‘transactions to the detriment of creditors’ as a matter of unfit conduct 2007-2012<sup>102</sup>**

	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012
<b>Cases citing ‘insolvent trading’ as a matter of misconduct</b>	36	44	40	35	7
<i>Cases citing ‘transactions to the detriment of creditors’</i>	161	246	391	392	161
<b>Total number of disqualification cases</b>	1,205	1,517	2,164	1,800	1,215

In contrast, the number of cases in which other ‘transactions to the detriment of creditors’ (such as ‘preference’ or ‘undervalue’ transactions contrary to ss.238 & 239 IA 1986) were cited as evidence of unfit conduct was much higher. In 2010-2011, for example, such conduct was cited in 392 of the 1,800 cases (21.8%), and 391 of the 2,164 (20.7%) disqualifications made in 2009-2010<sup>103</sup>.

The Insolvency Service data indicating that ‘insolvent trading’ is rarely identified in successful disqualification cases is matched by a more detailed study<sup>104</sup> of unfit conduct allegations in 500 disqualification *undertaking*<sup>105</sup> cases concluded in 2008. In that study, insolvent trading was cited in just 12 undertakings, whereas other conduct deemed detrimental to creditors (such a misuse of company property) was cited much more frequently.<sup>106</sup>

Data from disqualification cases does not therefore suggest that a relaxation of restrictions, even the substantial relaxation that would be needed to bring criteria for liability in s.214 into line with those applied in disqualification, would be likely to result in significantly increased levels of litigation under the provision. Indeed, the low incidence of insolvent trading in disqualification cases is particularly stark given that Insolvency Service guidance notes specifically directs the attention insolvency practitioners towards ‘insolvent trading’ as grounds for disqualification in their initial investigations of the affairs of insolvent companies<sup>107</sup>. To be sure, with even just 162 ‘insolvent trading cases’ in disqualification proceeding over a period of five years there may be *some* scope for increasing civil recovery; the number would certainly equate to more than the 29 reported s.214 cases across a 27 year period. However, nobody would claim, as made clear earlier, that those 29 cases represent the totality of litigation under s.214 across the period. Rather the point is that number of cases is indicative of low

(last accessed 10 October 2012).

<sup>102</sup> *Ibid.*

<sup>103</sup> *Ibid.*

<sup>104</sup> Williams, *Disqualification Undertakings*, n 96 above, 160-167.

<sup>105</sup> Disqualification undertakings represent the outcome of settlements in disqualification cases, see Company Directors Disqualification Act 1986, ss 1A, 7 (2A) & 8(2A) and generally Williams, *ibid*, 73-78.

<sup>106</sup> Williams, *ibid*, 165 & 206-208.

<sup>107</sup> The Insolvency Service, *Guidance Notes for the Completion of Statutory Reports and Returns*, July 2012 (URN 12/909), 23-24 and 40. The notes are available at

<http://www.bis.gov.uk/insolvency/Publications/publications-by-theme/insolvency-practitioners-publications>

(last viewed 12 June 2013). See also, The Insolvency Service, *Guidance Notes for the Completion of Statutory Reports and Returns*, 2001, 12.

levels of recovery under s.214, certainly as compared to other Insolvency Act provisions dealing with director misconduct. But it should be borne in mind too that that directors' 'impecuniosity' is likely to render some, perhaps many, disqualification 'insolvent trading cases' unsuitable for civil recovery proceedings. The fact therefore that we see exactly the same pattern of low incidences of insolvent trading in disqualification proceedings, where significantly more relaxed criteria for liability, as we see from other indicators is surely the most significant aspect of the disqualification data. For it shows that even where significantly more relaxed criteria are applied, incidences of 'insolvent trading', and therefore potential opportunities for civil recovery for 'wrongful trading', are limited, and so are limited regardless of the particular statutory rules in s.214.

Of course, it could be contended that incidences of insolvent trading are underrepresented in disqualification cases, but there is no evidence of this. The argument has been put that disqualification investigations may be skewed by cost and other factors towards less complex allegations of misconduct, such as unfair discrimination against Crown agencies in the payment of tax or failure to file statutory accounts and returns.<sup>108</sup> However, this argument would apply as equally to insolvent trading as it would to other evidentially complex 'transactions to the detriment of creditors' such as undervalue and preference transactions, which are still cited more frequently than insolvent trading in disqualification cases. So even accounting for possible bias within the disqualification system against investigation of complex directorial misconduct, we would still see that insolvent trading is a comparatively rare form of misconduct *regardless of the particular rules in s.214 IA 1986*. On that basis, there is simply no evidence to suggest that relaxation of the rules in s.214, even a far more radical relaxation than that currently proposed, would result in significant expansion of civil recovery under that provision. To put matters another way, this evidence suggests that low levels of litigation under s.214 are not, as is often assumed, principally the result of restrictions on s.214, but the result of limited *opportunities* for civil recovery under the provision.

### *C. Comparative Evidence: The Australian Insolvent Trading Rule.*

Analysis of the experience of the Australian insolvent trading rule provides still further evidence that relaxation of some of the key procedural restrictions in the UK remedy would be unlikely to significantly increase recovery under s.214. Insolvent trading rules have a substantial pedigree in Australia. Criminal liability for insolvent, or 'wrongful' trading was introduced in Australia in 1961,<sup>109</sup> and civil recovery following conviction of an offence of wrongful trading was introduced in 1964.<sup>110</sup> Stand-alone civil liability akin to that in s.214 has been available since 1981<sup>111</sup>. The elements of liability for wrongful trading in Australia, whether civil or criminal, are very similar to those in the UK, namely that a person can be held liable for wrongful trading where they allow a company to incur a debt at a time when they knew, or had reasonable grounds to believe, that the company was insolvent<sup>112</sup>. The scope of the Australian provisions has changed over time, but the Australian remedy has typically been wider than those applied in the UK. Australian law has, for example, allowed a much wider group of claimants to bring wrongful trading proceedings. Creditors, criminal prosecution authorities, corporate regulatory agencies (ASIC) and, since 1993, liquidators all enjoy standing to

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<sup>108</sup> See Williams, *Disqualification Undertakings*, n 96 above, Chap 5.

<sup>109</sup> Companies Act 1961 (Cth), s 303(3).

<sup>110</sup> See generally N Coburn, "Insolvent Trading in Australia: The Legal Principles", in I Ramsey (ed), *Company Directors' Liability for Insolvent Trading*, (Melbourne, 2000), 74-75.

<sup>111</sup> P. James, I M Ramsey & P. Siva, *Insolvent Trading – An Empirical Study*, University of Melbourne Faculty of Law, Research Paper No. 72 (2004) (available at <http://ssrn.com/abstract=555892>), 15-16.

bring claims against errant directors<sup>113</sup>. Wrongful trading actions in Australia are also not limited to companies that enter insolvent liquidation, but may be brought in respect of any company that incurs a debt when it is not solvent on a 'cash flow' basis,<sup>114</sup> provided that the directors have reasonable grounds for suspecting the solvency of the company. Liquidation is, though, a prerequisite for proceedings by a creditor<sup>115</sup> and (obviously) a liquidator.

However, despite the relaxed procedural framework, as compared to s.214 IA 1986, a 2004 study by James, Ramsey and Siva<sup>116</sup> revealed that only 88 civil claims for wrongful trading were reported in Australia in the 40-year period after civil liability was introduced in 1964<sup>117</sup>. A subsequent study has noted a particular dearth of cases under the current version of the Australian remedy, in spite of the fact that the provision was drafted with the intention of making claims for wrongful trading *easier* than under the predecessor provision<sup>118</sup> and continued adherence to a wide set of procedural rules. Australian law continues, for example, to accommodate claims by individual creditors<sup>119</sup>, albeit in respect of companies in winding up proceedings and subject to prior claims by a liquidator, and permits liquidators to encourage individual creditors to fund wrongful trading litigation by allowing liquidators to ask the court to sanction a special dividend to such creditors<sup>120</sup>.

Blame for the low number of cases reported in Australia has been attributed by one commentator to an apparent shift in Australian insolvency law towards voluntary administration proceedings which it is claimed are less likely to lead to personal claims against directors than formal insolvency proceedings,<sup>121</sup> and the fact that insufficient funds may be available in companies that do enter winding up to make civil recovery actions by liquidators viable<sup>122</sup>. No doubt these factors, if substantiated, would contribute towards a low number of wrongful trading actions in Australia, but what is remarkable is that the Australian remedy appears to have been no more effective over its near 50 year history than s.214 has been in its 27 years. Of course, it is possible that a coincidence of domestic factors could have conspired to render both rules ineffective in spite of significant differences in their scope, but the fact that the Australian rule has not performed well does not support claims that the blame for the poor performance of the UK remedy can be simply attributed to the particular restrictions in s.214, nor does it suggest that a significant upswing in litigation could be expected from the current reform proposals.

#### THE LIMITED ROLE OF THE SECTION 214 REMEDY.

So there is little evidence that the particular rules in s.214 are key driver behind low levels of litigation under the provision. Rather the principal explanation for the low impact of s.214 may simply lie in the fact that opportunities for civil recovery for wrongful or insolvent trading are limited regardless of the particular criteria applied to the rule. There are several grounds upon which it is

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<sup>113</sup> Corporations Act 2001 (Cth), ss.588G - 588U. See further N. Coburn, "Insolvent Trading In Australia: The legal Principles", in I Ramsey(ed), *Company Directors' Liability for Wrongful Trading*, n 110 above

<sup>114</sup> Corporations Act 2001 (Cth), s.95A

<sup>115</sup> Corporations Act 2001 (Cth), s.588R.

<sup>116</sup> James, et al, *Insolvent Trading – An Empirical Study*, n 111, above.

<sup>117</sup> *Ibid.*, table 3.

<sup>118</sup> A Herzberg, 'Why are there so few Wrongful Trading cases?' in I Ramsey(ed), *Company Directors' Liability for Wrongful Trading*, n 110 above, 148.

<sup>119</sup> See e.g. *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699, discussed by Herzberg, *ibid.*

<sup>120</sup> Corporations Act 2001 (Cth), s.588R.

<sup>121</sup> Herzberg, n 118 above

<sup>122</sup> Herzberg, *ibid.*

argued in the remainder of this article that this is likely to be the case and why, therefore, a reformed, or unreformed wrongful trading remedy is likely to play only a limited role in creditor protection.

### *The Frequency of 'Insolvent Trading'.*

Evidence from UK director disqualification cases suggest that 'insolvent trading' may not be a particularly common form of director misconduct, or at the very least that it is much less common than other form of directorial misconduct connected to insolvency. The Cork Committee was clearly of the view that the problem of directors' 'indifference' to corporate debts as a result of perverse incentives from limited liability was significant in its call for a 'radical extension' of civil liability to be introduced to tackle the problem as a matter of 'urgent necessity'<sup>123</sup>. Acceptance of Cork's implicit claim that the problem was widespread drove early expectations of the impact of s.214<sup>124</sup>, and those expectations have, in turn, underpinned the subsequent near-consensus that the remedy has 'underperformed' relative to the scale of the problem against which it was directed. In fact, however, the Cork Report did not present any empirical evidence as to the scale of the problem of 'indifference and lack of concern' by corporate managers, citing only anecdotal evidence from its consultation<sup>125</sup> in making the 'urgent' case for the new rule.

To be sure, the claim that limited liability increases the likelihood of 'indifference' to levels of corporate debt has a firm grounding in the general literature on limited liability<sup>126</sup>, and is particularly prominent in the literature regarding insolvent trading remedies<sup>127</sup>. But again, empirical evidence as to the incidence of the mischief is lacking and it seems, rather, to be assumed that the risk is significant and necessitates a regulatory response because transaction costs and information asymmetries prevent many creditors from effectively managing the risk themselves<sup>128</sup>. In reality, however, evidence from a number of empirical studies challenges the notion that financially distressed companies necessarily engage in 'risk-shifting' and, on the creditor side, patterns of risk adjustment across classes of creditors are complex and easy assumptions of 'market failure' are likely to be misleading.

On the firm side a recent study by Gilje<sup>129</sup> found that risk taking in small US companies in the oil and gas industry actually *reduced* as the financial conditions of the firm deteriorated. Gilje's conclusions follow those of Andrade and Kaplan<sup>130</sup> who, in a study of 31 firms, found no evidence that financial distress caused companies to engage in risk-shifting through "unusually risky" investment decisions. Of course, Gilje's study analysed evidence of investment decisions (using firm disclosures to the US Securities and Exchange Commission) in publicly traded US companies active in a particular sector of economic activity. But the fact that the study, consistent with others<sup>131</sup>, failed to find empirical evidence of 'risk-shifting' to creditors in times of financial distress challenges assumptions that limited liability in fact creates significant new risks for creditors in a pre-insolvency context.

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<sup>123</sup> Cork Report, n 4 above, para 1805.

<sup>124</sup> See e.g. Prentice, "Corporate Personality", n 13 above.

<sup>125</sup> Cork Report, n 4 above, at para. 1741.

<sup>126</sup> See e.g. Landers, n 19 above; Halpern et al, n 20 above.

<sup>127</sup> See e.g. Prentice, "Corporate Personality"; Keay "Wrongful Trading"; Davies & Worthington, *Gower & Davies: Principles of Modern Company Law*, all at n 7 above.

<sup>128</sup> *Ibid.*

<sup>129</sup> E Gilje, "Do Firms Engage in Risk Shifting? Empirical Evidence", presented at *Oxford-LSE Law and Finance Conference*, 23 May 2014, (available at <https://test-intranet.law.ox.ac.uk/ckfinder/userfiles/files/Erik%20Gilje%20paper.pdf>)

<sup>130</sup> G Andrade & S N Kaplan, "How costly is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions that became Distressed" (1998) 53 *Journal of Finance*, 1443,1471.

<sup>131</sup> See e.g. G Andrade & S N Kaplan *ibid*; J Rauh, "Risk Shifting versus Risk Management: Investment Policy in Corporate Pension Plans". (2009) 22 *Review of Financial Studies* 2687.

The fact that many directors are exposed to financial risks from the failure of their firms, in spite of their limited liability, such as through the provision of personal guarantees for corporate debt<sup>132</sup>, or the provision of loans to their company<sup>133</sup>, is, for one thing, likely to reduce the risk of unusually risky investment decisions in the financial twilight zone. And this is to say nothing of the fact that many directors' concern for their business reputation, and that of the business, might prevent them from engaging in insolvent trading<sup>134</sup>. But even assuming, that risk-shifting does arise in some cases, a wide variety of security and quasi-security devices are nonetheless available to creditors, of all classes, in seeking to manage such credit risks.<sup>135</sup> And even where it is uneconomic for creditors to tailor their terms of credit to individual debtors, experience will no doubt enable them to structure their pricing policy in such a way as to cover the likely level of default across all debtors<sup>136</sup>. None of this, of course, is to say that 'perverse incentives' are not created by limited liability and that actual instances of insolvent trading born of indifference and lack of concern by corporate managers do not arise. They no doubt do in some cases. But the fact that this *might* happen tells us nothing of the frequency with which it actually *does* happen and, therefore, whether the levels of reported litigation under a statutory remedy to deal with the problem are or are not appropriate to the incidence of the misconduct.

There is therefore nothing in the Cork Report, or the wider literature,, that provides a sound evidential basis upon which it could be concluded that the current modest levels of litigation under s.214 are dramatically out of line with instances of 'insolvent trading'. In fact, the evidence that we do have from directors' disqualification cases etc., suggests that current levels of litigation under s.214 are very much *in line* with the broader incidence of insolvent trading, and this fits with the picture of low litigation that we see in comparative analysis of the Australian 'wrongful trading' rule.

#### *Directors' Personal Solvency.*

It is also the case that, even where insolvent trading does occur, civil recovery such as that offered by the wrongful trading remedy may be of little benefit to creditors because 'wrongdoing' directors have themselves suffered significant financial loss as a result of corporate failure. The ability of a wrongdoing director to compensate creditors from his or her personal wealth is crucial to successful recovery under the wrongful trading remedy<sup>137</sup>. Where a director has suffered significant personal financial loss as a result of corporate failure, then it simply may not be worth a liquidator, administrator, creditor or any other person pursuing that director for civil recovery, regardless of whether insolvent trading has occurred. Cheffins argues that creditors would be unlikely to choose a generalised personal liability rule such as that in s.214 in bi-lateral contracts with directors because of such fluctuations in director wealth, and so may be little interested in utilising the statutory remedy<sup>138</sup>.

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<sup>132</sup> Freedman and M. Godwin, "Incorporating the Micro business: Perceptions and misperceptions", in A. Hughes and D. Story, *Finance and the Small Firm*, (London, 1994).

<sup>133</sup> See e.g. A. Hughes, "Finance for SME's: A UK perspective" (1997) 9 *Small Business Economics* 151; R. Avery, R. Bostic & K. Samolyuk, "The Role of Personal Wealth in Small Business Finance", (1998) 22 *Journal of Banking and Finance* 1019.

<sup>134</sup> On the general nature of reputational concerns in preventing risk-shifting by managers and firms see e.g. D. Hirshleifer & A. V. Thakor, "Managerial Conservatism, Project Choice, and Debt" (1992) 5 *Review of Financial Studies* 437; D. W. Diamond, "Reputation Acquisition in Debt Markets." (1989) 97 *Journal of Political Economy* 828.

<sup>135</sup> Cheffins, n 47 above, 81-82

<sup>136</sup> *Ibid.*

<sup>137</sup> *Ibid.*

<sup>138</sup> *Ibid.* C.f. R. J. Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain" 59 (2000) *CLJ* 335, 345-350. The argument was later revised in R. J. Mokal, *Corporate Insolvency Law*, n 15 above, 278-281.

There is a body of evidence to suggest that directors of smaller companies are significantly exposed to financial risk from the failure of their companies, either through the provision of personal guarantees for corporate debt<sup>139</sup>, or through self-financing of the companies business through the provision of loans etc.<sup>140</sup> In such cases, corporate insolvency may have significant detrimental effects on the personal finances of potential respondents to a wrongful trading claim, such as to preclude any realistic chances of civil recovery. In Freedman and Godwin's study of 'micro-business'<sup>141</sup>, for example, over 50% of incorporated owner-managers were found to have given personal guarantees for corporate debts, which, if replicated across larger swaths of small companies, would suggest that civil recovery proceedings could prove fruitless in large numbers of corporate insolvencies. Indeed, as is set out further below, analysis of public records of individual bankruptcies suggests a significant number of directors who have been made subject to civil recovery under s.214 declared bankruptcy shortly after judgement was entered against them. Liquidators, creditors or administrators will no doubt be aware of the likelihood of similar outcomes in many cases, reducing the incentive for them to litigate in the first place.

So fluctuations in director wealth are likely to be a significant disincentive to pursue civil recovery proceedings. This must though be seen in conjunction with evidence as to limited instances of wrongful trading in corporate insolvency cases. Fluctuations in director wealth do not, of course, affect incentives to sanction 'insolvent trading' in director disqualification proceedings, suggesting a prior reason for the limited impact of s.214 (namely that insolvent trading is rarely uncovered in investigations of the affairs of insolvent companies). Against this backdrop, though, the impecuniosity of potential respondents is likely to narrow still further the scope for application of the wrongful trading remedy.

#### *Patterns of Misconduct and the s.214 Rule.*

Further evidence of limited scope for application of the wrongful trading remedy is suggested by analysis of cases reported under the s.214 provision. The reported cases under s.214 typically involve highly complex fact patterns that do not confirm to the notion of 'wrongful trading' presented by the Cork Report. The conduct complained of by liquidators in s.214 cases often involves deliberately self-interested misconduct on the part of a wrongdoing director that does not fit the simplistic pattern of 'indifference and lack of concern' to corporate debt because of the insulating effect of limited liability that is typically cited as the core concern of the s.214 rule. In part, the cases therefore highlight further the unreliability of Cork's analysis as a tool for predicting likely levels of litigation under the provision and undermine claims that the low number of reported cases necessarily evidences *underperformance* of the sanction. More than this though, the fact patterns of the cases show that the conduct sanctioned under s.214 was often equally capable of being remedied under another Insolvency Act provision. This is significant because it shows that creditors may have little need for the wrongful trading remedy in cases of actual wrongdoing.

In *Re DKG Contractors Ltd*<sup>142</sup>, by way of example, the liquidator sought to recover £417,763 from the respondent directors which it was alleged had been transferred from the insolvent company, DKG, to

<sup>139</sup> J. Freedman and M. Godwin, "Incorporating the Micro business: Perceptions and Misperceptions", n 132, above.

<sup>140</sup> See e.g. A. Hughes, "Finance for SME's: A UK perspective" (1997) 9 Small Business Economics 151; R. Avery, R. Bostic & K. Samolyuk, "The Role of Personal Wealth in Small Business Finance", (1998) 22 *Journal of Banking and Finance* 1019.

<sup>141</sup> Freedman and Godwin, n 132, above

<sup>142</sup> [1990] BCC 903.

one of its directors, who was also a significant creditor of the company, in the 10 months leading up to its insolvency. The liquidator alleged that the transfer of the sums amounted to (i) a breach of duty for which recovery could be made under s 212 of the IA 1986, because the payments were made at a time when the company could not meet its debts as they fell due; (ii) a transaction at a preference contrary to s 239 IA 1986, in so much as the payments preferred one of the company's creditors (the director) over others; and (iii) wrongful trading contrary to s.214, it being contended that throughout the period in which the sums were transferred the respondent directors knew, or ought to have concluded that the company could not avoid insolvent liquidation. The trial judge found that all of the allegations were made out on the facts and held the directors under a *concurrent* liability to repay the sum of £417,763 under ss. 212, 238 and 214, with practical effect that satisfaction of liability under s.212 was held to discharge liability under s.239 and s.214.

The first thing to note about DKG from the perspective of our analysis of the wrongful trading remedy is that the claim in the case was not that the directors of DKG had indifferently 'traded whilst insolvent' because they felt themselves protected from downside risks by 'limited liability'. Rather, the claim concerned a series of self-interested transactions that were intended to prefer a director-creditor over the general body of the company's creditors, with liability arising under s.214 because the relevant transactions took place at a time when the directors 'ought to have known' that the company could not avoid insolvent liquidation. The second thing to note is that liability under s.214 in fact provided no benefit to the creditors of DKG in that it added nothing to the sums that were in any case recoverable under s.212 and s.239 IA 1986.

DKG is not an isolated example of a s.214 case turning on self-interested behaviour by directors and/or overlapping liabilities under different Insolvency Act provisions. Similar overlapping liabilities were alleged by liquidators in 13 of the 16 fully reported cases determining the question of liability under s.214 identified in the author's study of reported s.214 cases<sup>143</sup>. In eight of the cases, recovery was also sought under s.212 in relation to alleged 'misfeasance of breach of duty' by the respondent director. In four cases recovery was sought in relation to a 'transaction at a preference' contrary to s.238<sup>144</sup> of the Insolvency Act, and in a further four cases recovery was sought in relation to a transaction at a preference contrary to s.239.

To be sure, in some of these cases s.214 did provide apparently significant 'new' recovery for creditors in spite of overlapping liabilities<sup>145</sup>. In *Re Bangla Television Ltd*, for example, the liquidator was successful in recovering from the directors the lost value of a transfer of assets from the company that was made by the respondent directors, for no consideration, to another company they controlled. The transaction in question was a clear 'transaction at an undervalue' contrary to s.238 IA 1986, it being a clear attempt by the directors to prevent the assets of a failing company falling into the hands of creditors in liquidation proceedings. Proceedings under s.238 had, though, yielded little benefit for creditors due to the subsequent insolvency of the company to which the assets were transferred. The liquidator consequently sought to establish personal liability on the part of the directors for the lost value to the Bangla by (successfully) arguing that the transfer was made at a time when Bangla had no reasonable prospect of recovery and therefore was caught by s.214. It should be noted, though, that

<sup>143</sup> See n 38 above, and text thereto.

<sup>144</sup> A transaction at a preference is a pre-insolvency transaction that has the effect of putting some of the company's creditors in a better position than other creditors where a desire to so prefer the creditors concerned motivated the transaction (see e.g. *Re M C Bacon Ltd (no 2)* [1990] BCLC 607 and Further, Finch, 'Corporate Insolvency Law', n 53 above, 563-564).

<sup>145</sup> See e.g. *Re Bangla Television Ltd* [2009] EWHC 1632; *Re Produce Marketing Consortium Ltd* [1989] BCLC 520

there appear on the facts of the case to be no reason why the liquidator could not have sought recovery from the directors personally as part of the claim under s.238. A declaration of personally liability for directors in respect of the relevant transaction falls clearly within the scope of s.238(3) IA 1986 which permits the court to make ‘whatever order it thinks fit’ to remedy an undervalue transaction, and indeed it is well within the court’s power to ‘impose an obligation on any person’ regardless of whether they are the beneficiary of the preference, set out in s.241(2) IA 1986.

A further example of the ambiguity of apparently direct benefits of s.214 liability arising from the complex nature of directors’ misconduct can be seen in the case of *Re Idessa (UK) Ltd*<sup>146</sup>, where again the misconduct complained of had its root in self-interested behaviour rather than simple ‘trading with indifference’ to the creditors’ plight. In *Idessa*, the liquidator brought claims against the respondent directors under ss.212, 238 and 214 of the Insolvency Act in respect of payments made from the insolvent company (Idessa) for the benefit of respondent directors at a time when it was insolvent, it being alleged that the payments amounted to a breach of duty by the directors, transactions at an undervalue, and wrongful trading. The judge found the majority of the allegations under ss.212 and 214 made out (making it unnecessary to consider the claim under s.238), and the directors were ordered to pay a total of £1,438,513.23 in respect of liabilities under both provisions. £ 340,411 of the liability was assigned by the judge to s.212, that being the sum transferred to the directors before it could be established that the company had no reasonable prospect of avoiding insolvent liquidation. This resulted in nominal recovery under s.214 being set at £1,098,102, which was the sum by which the liabilities of the company had increased after it was held to have no reasonable prospect of avoiding liquidation. However, whilst this would suggest that significant recovery was made under s.214 that would otherwise be unavailable, on closer inspection it is by no means clear that all of the sums allocated to s.214 could not have been recovered under s.212. The trial judge acknowledged<sup>147</sup>, for example, that the figure for the net s.214 liability included a tax liability of £274,966.11 which could have been recovered under s.212 as a sum paid in breach of directors’ duties. The decision to allocate recovery for the liabilities to s.214 was therefore a matter of convenience rather than a matter of law.

Section 212 IA 1986 permits a liquidator of an insolvent company to bring proceedings against directors in respect of any “misfeasance or breach of fiduciary duty” committed by them in the course of their management of a company. Directors, of course, do not owe direct duties to protect the interests’ of corporate creditors in solvency or insolvency. However, following the recognition of the relevance of creditors’ interests to those of the company in *Liquidator of West Mercia Safetywear v Dodd*<sup>148</sup>, director liability for ‘insolvent trading’ may be established under s.212 where the director’s actions are found to disregard the collective interests of creditors in the immediate period prior to insolvency.<sup>149</sup> This is true in respect of directors who continued trading an insolvent company through ‘indifference and lack of concern’ for creditors interests, or directors who sought to defeat creditors’ interests by removing property from an insolvent, or near insolvent, company. Moreover, civil liability may be established under s.212 without the need to meet the criteria set down in s.214.

It is little surprise, therefore, that in 8 of the 16 fully reported decisions under s.214, claims were also advanced against respondent directors under s.212 for misfeasance or breach of duty. The reports show, for example, overlap in the substantive claims under ss.214 and 212 in *Roberts v Frohlich*<sup>150</sup>

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<sup>146</sup> [2011] EWHC 804 (Ch); [2012] BCC 315.

<sup>147</sup> *Ibid*, at [133] & [135]

<sup>148</sup> [1998] BCLC 250, 252-253. See further n 65 above, and text thereto.

<sup>149</sup> *Yukong Lines of Korea v Rensburg Investments Corporation* [1998] WLR 294, at 321 (Toulson J).

<sup>150</sup> [2011] EWHC 257

and *Rubin v Gunner*<sup>151</sup>, though the reports in both cases give few details of the quantification of loss under the various heads of liability. Overlap in liabilities is also evident in *Singla v Hedman*<sup>152</sup> where the trial judge talked of ‘breaches of duty’ by the respondent directors as the basis for their liability under s.214.

However, whilst the liability provided by the rule s.214 may, in light of these developments in directors’ duties, offer little that is unique to creditor protection, the rule has, at least until recent times, held a practical advantage over liability under s.212. This is that the proceeds of s.214 actions are not regarded as the ‘property’ of the company and so are not subject to the rights of floating charge holders<sup>153</sup>. As such, s.214 liability is likely to be particularly useful for unsecured creditors of insolvent companies. In contrast, sums recovered under s.212 are regarded as property of the insolvent company because they arise before liquidation and so may be caught by an appropriately drafted floating charge<sup>154</sup>. The advantage that s.214 proceedings might be seen to enjoy in this respect, however, must now be seen in light of the ‘prescribed part rule’ in s 176A IA 1986. This rule was first introduced into the Insolvency Act 1986 by the Enterprise Act of 2002 and provides that ‘prescribed part’ of the assets of an insolvent company subject to a floating charge shall be held back by the liquidator from the charge-holder to be distributed to the unsecured creditors of the insolvent corporation. As such, unsecured creditors should derive some benefit from the proceeds of misfeasance proceedings even where that ‘property’ of the company is subject to an appropriately drafted floating charge.

#### *Post-Judgement Solvency of Respondent Directors.*

An important note should be added about the post-judgement solvency of directors made liable to civil recovery under s.214. Nineteen individuals were made subject to civil liability in reported s.214 cases between 1986-2013. The amount of biographical detail provided about those respondents obviously varies significantly from case to case. However, it was possible to check biographical details of the majority of respondents with details of individual insolvencies recorded in the official *Gazette* using *The Gazette’s* online search facility.<sup>155</sup> This search suggests that, with a high degree of likelihood, seven of those respondent directors were declared bankrupt, or filled for bankruptcy, within six months of judgement having been entered against them under s.214. These likely bankruptcies were identified principally by the names of respondent directors in s.214 cases exactly matching the names of individuals declared insolvent in *Gazette* notice. A variety of other data extracted from the relevant case report was used to corroborate initial matches, such match including the geographical location of the individual insolvent matching that of the insolvent company and the occupation of the relevant individuals listed in the individual insolvency register as being “Company Director”. The likely bankruptcy rate amongst directors subject liability s.214 liability on this data would therefore be in excess of one-third. Of course, the sample size here is a very small, and one and one should be cautious about drawing too wide a conclusion as to the post-liability solvency of directors across the board. Nonetheless, the data lends support to the notion that many directors simply may not be worth pursuing for civil recovery and certainly shows that creditors are likely to have gained little from s.214 liability (or any other Insolvency Act liability), in a significant number of the reported cases.

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<sup>151</sup> [2004] EWHC 315

<sup>152</sup> [2010] EWHC 902

<sup>153</sup> *Re MC Bacon Ltd* [1991] Ch 127, 138.

<sup>154</sup> Finch, *Corporate Insolvency Law*, n 53 above, 705.

<sup>155</sup> Available at <https://www.thegazette.co.uk>

## CONCLUSION

There is little doubting the importance that is attached to the wrongful trading remedy by many policy makers and commentators in efforts to combat abuses of limited liability by rogue directors. There is little room too for doubting the widely held view that the limited impact of s.214 can, in the main, be attributed to statutory restrictions on the scope of the remedy. It is little surprise therefore that proposals to extend the scope of the remedy should be seen as an effective method to improve financial redress for creditors of failed companies.

The proposed reforms to the wrongful trading remedy are, however, modest and would seem to hold out little hope of achieving their stated goal a significant expansion in civil recovery from wrongdoing directors, and as a result, neither are they likely to significantly enhance the deterrent impact of the sanction. Including administration proceedings within the scope of the section would bring relatively few new cases within the scope of the rule and it seems unlikely that a significant market for wrongful trading actions would develop if office holders were given rights to sell or assign the proceeds of causes of action under the rule. The most significant flaw in the reform proposals is not, however, their over optimism about expanding the scope of the the wrongful trading rule. It is rather the fact that they proceed on an assumption that that current modest levels of litigation represent a significant underperformance of the sanction relative to the problem of wrongful trading.

The available evidence, suggests that this assumption is without foundation and even more radical reform of wrongful trading rule than that proposed would be unlikely to transform it from being a rarely used remedy. Data from almost 8,000 directors' disqualification cases suggest that 'insolvent trading' is rarely identified in the affairs of in affairs on insolvent companies, where radically different criteria are applied and cost factors are less of a disincentive to litigation. This is lent support by comparative analysis of the Australian wrongful trading rule and effective changes to the funding of insolvency litigation made by the s.174ZA IA 1986. On top of this, doubts over the solvency of respondent directors are likely to narrow still further opportunities for civil recovery under s.214, and overlapping liabilities under other provisions of the IA may mean that creditors are often not reliant on the wrongful trading rule to obtain redress against wrongdoing directors.

None of this is, of course, to say that wrongful trading does not occur and that on some occasions the remedy may provide useful redress to creditors, or even deter some wrongful conduct, in terms of providing compensatory redress to creditors the post-liability insolvency of respondent directors may raise doubts over the exact benefits of the rule. But what has been argued here is that expectations of the *potential* impact of the wrongful trading rule are based on unfounded claims about the scale of wrongful trading, not least those evident in the Cork Report. There is simply no evidence that Cork's call for a 'radical' extension in civil liability through the introduction of a wrongful trading was ever likely to realised in the sense of large-scale liability orders under s.214. Nor is there any reasonable basis upon on which to conclude that current modest levels of *reported* litigation under the rule are radically out of line with instances of insolvent trading. There is, as such, no ground upon which to suppose that reform of wrongful trading remedy is likely to have anything other than a marginal effect on the impact of the provision, either in terms of securing 'better compensation' for creditors, or in terms of deterring misconduct. It is, as such, vital that we look beyond the implicit assumptions of the Cork Report in evaluating both the current performance of the wrongful trading remedy and the likely impact of reforms to the rule. To be sure s.214 may be a useful tool in some cases, but the available evidence suggests that its role in regulating directors is inherently limited by factors independent of the particular criteria included in a statutory rule. The gains of reform are, as such, likely to be limited.