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Judge refuses liquidator's wrongful trading application

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David Bowden, freelance independent consultant, comments on the consequences of *Re Ralls Builders Limited*, what lessons can be learned from this case and what will happen next.

Original news

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

A High Court judge has refused to grant an application made by a liquidator. The liquidator claimed that an insolvent company had engaged in wrongful trading. In a lengthy reserved judgement after a 15 day trial, Snowden J has dismissed the liquidator's claim and ruled in favour of the former directors of the insolvent company. The judge arrived at this decision by construing 2 sub-sections of s214 of the Insolvency Act 1986 in the former directors' favour.

What was the background to the application, briefly?

The joint liquidators of Ralls Builders Limited ('Ralls') company commenced proceedings against Ralls' directors for wrongful trading under section 214 of the Insolvency Act 1986 ('IA'). The amount claimed originally was in excess of £1.13 million, but was reduced by the end of the 15 day trial to somewhere between £600,522 and £987,725.

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

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

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

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

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

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

What were the legal issues the judge had to decide?
The judge had to construe 2 subsections of IA s214 on wrongful trading. Section 214(1) and (3) provide:

> '*(1)Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.*
>
> *'(3)The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.*'

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

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

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

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

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

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

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

What will happen next?
There will be a further contested hearing before the judge on 3 March 2016. This will have to deal with 3 issues.

The first issue is whether, in the light of the judge's ruling that there was no wrongful trading, he should nevertheless make a declaration that the directors should make a contribution to the assets under IA s214(1) in respect of the costs and expenses of the administration and subsequent liquidation of the Company.

Secondly, the judge will also have to decide what order, if any, to make against the former directors under section 10 of the Company Directors Disqualification Act 1986 ('CDDA'). However the power under the CDDA is only triggered where a court has made a declaration that a person is liable to contribute to a company's assets under IA s214(1).

Finally the judge will have to decide who has been the winner in this litigation and make an order for costs. This case was started before the costs budgeting regime was in place. It is likely that costs will be sent for detailed assessment but the judge will have to decide what payment on account to order in the meantime.

To what extent is the judgment helpful in clarifying the law in this area?
The judge refers to 8 previous judgements in total but there are 3 in particular that help him to shape his interpretation of IA s214(3).

In *Re Kudos Business Systems* **[2011] EWHC 1436 (Ch), [2012] 2 BCLC 65,** Deputy Judge Sarah Asplin QC ruled that there could be no doubt that a director was in breach of his duties in allowing the company to pay away sums advanced to it by its customers. At the very least, a director was negligent when making those payments at a time when he must have known that there was no prospect of the services being provided. A reasonably diligent person, with the general knowledge, skill and experience reasonably expected of a sole director, would not have acted as he did. His actions were indicative of a total disregard for his duties which, in the circumstances, included the safeguarding of the company's creditors. Because of this the judge ruled that the director was also guilty of wrongful trading pursuant to IA s214 from the date at which he should have known that there was no reasonable prospect of the company avoiding an insolvent liquidation.

Continental Assurance Co of London PLC **[2007] 2 BCLC 287, [2001] BPIR 733, [2001] All ER (D) 229 (Apr),** Park J found the directors took a wholly responsible and conscientious attitude, both to the company's position and to their own responsibilities as directors, at all times from and after the first crisis board meeting when major and unexpected losses were reported to them. The directors did not ignore the question of whether the company could properly continue to trade - on the contrary they considered it directly, closely and frequently. The directors were entitled to have regard to the forecast presented by the company's finance director and its auditors when they took the crucial decision to carry on trading. They were entitled to have regard to the balance sheet which was before them, to the opinion of the finance director and the auditors that the company was solvent. They were entitled to include as part of their thinking that a close and careful watch should be kept on claims lest any other unexpected losses should emerge from past trading and require an urgent reconsideration of the position. The court did not accept the liquidators' submission that the directors ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

Finally, in *Re Purpoint* **[1991] BCLC 491, [1991] BCC 121,** Vinelott J found that although there was evidence to suggest that the company, even when it started business, was not in a healthy state, it would be imposing too high a standard to hold that its director should have appreciated that the company was doomed from the start. Because of the company's lack of records, it was impossible to determine the company's net liabilities and in determining the extent of the director's liability under IA s214 the court should aggregate the debts and impose liability on the director for them. The purpose of an order under IA s 214 is to recoup the loss to the company so as to benefit all of the company's creditors and the court has no jurisdiction to direct payment to a particular class of creditors.

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

> '*the fact that any contribution to be made under section 214(1) must be distributed* pari passu *among the general body of unsecured creditors of the company is a significant pointer to the fact that the purpose of section 214 is not to provide differential redress for individual creditors, depending upon an assessment of the extent of their loss caused by the period of wrongful trading.'*

And he sums up the authorities and his approach in this way:

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

What practical lessons can those advising take away from this case?

The judge does not mince his words when he sets out his assessment of all the witnesses. Some witnesses come in for criticism for having tailored their recollections. The business was advised by Mr Tickell. He was diagnosed with cancer and the judge dismissed an application to adjourn the case until he was better. Mr Tickell had been meticulous in his work. Whilst he had attended meetings with the directors throughout the period leading up to its eventual collapse, he had sent the directors detailed letters of advice. These included warnings on the risk of a wrongful trading claim. The judge felt that Mr Tickell would not be able to give much more

evidence above and beyond the copy documents in his firm's file. Those advising insolvent or potentially insolvent businesses should continue to give warnings about the risks and consequences of unfair trading.

Here the directors were able to show from their books that during the summer they had traded profitably. This entailed a detailed examination of their books and the assistance of an expert to bring out the true financial position. The directors said they had contracts with local authorities to carry out building and repair works over the time schools were closed over the summer. This may not be a position that all insolvent businesses can make out. Nevertheless the maintenance of good books by a business in the period before an insolvency will be vital to show whether a liquidator can indeed make good on the facts a claim under IA s214.

Many insolvent businesses will be tempted to try and find a 'white knight' to save them. Mr James was called by neither side to give evidence. What the court had was an unsigned letter of intent which was brief. There were some emails and text messages from one of the directors about his attempts to contact and meet with Mr James. There was also a draft sale purchase agreement that the business's solicitors drafted. The judge had to consider this. In a testy exchange in cross-examination, Mr Ralls retorted that '*you don't ask the Queen what's in her purse*'! The judge rejected the view that the directors had made up the failed sale with Mr James to save their own skins. The judge decided instead that the director in charge of the negotiations did not have to skill set necessary to close a deal with such a wealthy investor. Those advising insolvent businesses, who wish to rely on this as an escape route, should ensure that sufficient records are kept. This may not always be easy where there are face to face meetings or conference calls, but attendance notes must be kept and appropriate follow up action dealt with promptly.

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

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