The Directors' Duty To The Creditors of a Financially Distressed Company: A Perspective From Across The Pond

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Introduction

There has recently been a revival of interest in the subject of the directors' duty to creditors where the company is financially distressed[1] and it was considered in some detail by the Company Law Review Steering Group, which was set up by the government to review core company law in 1998[2] and reported in 2001.[3] Although the duty is now generally regarded as well established in principle,[4] there are important aspects of it which remain unclear and the role of the duty in modern law has been questioned. This paper briefly outlines the development of the duty in Great Britain before going on to explore the uncertainties surrounding the duty, the treatment of the duty by the Company Law Review Steering Group, the government's response, and the role of the duty in modern British law.

The Development of the Duty in Great Britain

As has been noted elsewhere,[5] the development of the duty has been well documented,[6] but a brief outline may usefully be given here.

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[1] For some of the most recent literature, see A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379; A Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' 2003 66 MLR 665; A Keay, 'Directors Taking Into Account Creditors Interests' 2003 Co. Law 300; A Keay, 'Another Way of Skinning A Cat: Enforcing Directors' Duties For The Benefit Of Creditors' 2004 Insolv. Int. 1; D Milman, 'Strategies for Regulating Managerial Performance in the "Twilight Zone" - Familiar Dilemmas: New Considerations' [2004] JBL 493; A Keay, 'A Theoretical Analysis Of The Directors' Duty To Consider Creditor Interests: The Progressive School's Approach' 2004 JCLS 304; A Keay, 'Directors' Duties - Do Recent Canadian Developments Require A Rethink In The United Kingdom On The Issue of The Directors' Duties To Consider Creditor Interests' 2005 Insolv. Int. 65. See also V Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, Cambridge, 2002).The duty may, in fact, be more accurately expressed as a duty to take into account the interests of creditors which arises at the point where those interests are at risk, but this is a familiar and convenient shorthand which will accordingly be used here.

[2] See *Modern Company Law for a Competitive Economy* (March 1998).

[3] *Modern Company Law for a Competitive Economy: Final Report* (July 2001).

[4] Although it has been argued that no such specific duty in fact exists because in each of the cases where it has been referred to, liability was clearly based on other grounds: see L Sealy 'Directors' Duties - An Unnecessary Gloss' [1988] CLJ 175 and 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon, Oxford, 1994).

[5] See, for example, A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379 at 381.

[6] See, for example, L Sealy 'Directors' Duties - An Unnecessary Gloss' [1988] CLJ 175; N Hawke, 'Creditors' Interests in Solvent and Insolvent Companies' [1989] JBL 54; V Finch, 'Directors' Duties Towards Creditors' 1989 Co. Law 23; C Riley, 'Directors' Duties and the Interests of Creditors' 1989 Co. Law 87; D Prentice, 'Creditor's Interests and Director's Duties' 1990 OJLS 265; R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' 1991 JBL 1; R Grantham, 'Directors' Duties and Insolvent Companies' 1991 MLR 576; R Sappideen, 'Fiduciary Obligations to Corporate

The development of the duty in Great Britain builds on Commonwealth authority. The duty is generally regarded as originating in the famous *dictum* of Mason J in the Australian High Court case of *Walker v Wimborne*[7] to the effect that the directors of a company in discharging their duty to the company are required to take into account the interests of its shareholders and creditors, any failure to take into account the interests of creditors having adverse consequences for the company as well as the creditors themselves.[8] The approach in that case was followed in other Commonwealth cases which have also influenced the development of the law in Great Britain, most notably the cases of *Nicholson v Permakraft*[9] and *Kinsela v Russell Kinsela Pty Ltd*.[10]

In Great Britain, the first signs of recognition of the duty appeared in the case of *Lohnro Ltd V Shell Petroleum Co Ltd*[11] where Lord Diplock stated that the best interests of the company, in which the directors were bound to act, were 'not exclusively those of its shareholders but may include those of its creditors'.[12] Other cases followed. In *Re Horsley and Weight Ltd*,[13] Buckley LJ spoke of directors owing an indirect duty to creditors not to permit any unlawful reduction of capital.[14] In *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd and ors*,[15] Dillon LJ appeared not to recognise the existence of the duty, stating clearly that directors owed fiduciary duties to the company but not to the creditors, present or future.[16] In the later case of *West Mercia Safety Wear Ltd v Dodd*,[17] however, he distinguished *Multinational Gas and Petrochemical Co* on the basis that in that case, the company had been amply solvent[18] and he went on to quote with approval another famous *dictum*, that of Street J in *Kinsela v Russell Kinsela Pty Ltd*,[19] to the effect that where a company is insolvent, the interests of the creditors intrude and they become prospectively entitled to displace the power of the directors to deal with the company's assets because in a practical sense the company's assets are their assets.[20]

Creditors' 1991 JBL 365; V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in A Clarke (ed) *Current Issues in Insolvency Law* (Stevens, London, 1991); D Prentice, 'Directors, Creditors, and Shareholders' in McKendrick (ed) *Commercial Aspects of Trusts and Fiduciary Obligations* (Clarendon, Oxford, 1992); R Grantham, 'The Content of the Director's Duty of Loyalty' 1993 JBL 149; L Sealy, 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law*, Feldman and Meisel (eds) *Corporate and Commercial Law: Modern Developments* (Lloyds of London Press, London, 1996) Chapter 9 and the literature cited at note 1.

[7] (1976) 137 CLR 1.
[8] *Ibid* at 6-7.
[9] [1985] 1 NZLR 242.
[10] (1986) 4 NSWLR 722.
[11] [1980] 1 W.L.R. 627.
[12] *Ibid* at 634.
[13] (1982) 3 All ER 1045.
[14] *Ibid* at 1055-6.
[15] (1983) 2 All ER 563.
[16] *Ibid* at 585.
[17] (1988) BCLC 250.
[18] *Ibid* at 252. The significance of the solvency or otherwise of the company to the existence of the duty is discussed further below.
[19] (1986) 4 NSWLR 722.
[20] *Ibid* at 730.

The existence of the duty was also recognised by the House of Lords in *Winkworth v Edward Baron Development Co Ltd*,[21] the Court of Appeal in *Brady v Brady*[22] and (indirectly) in *Re Welfab Engineers Ltd*[23] and, more recently, in *Yukong Lines of Korea v Rendsberg Investment Corp of Liberia (No 2)*,[24] *Facia Footwear Ltd v Hinchcliffe*,[25] *Clydebank Football Club Ltd v Steedman and ors*,[26] *Re Pantone 485 Ltd*,[27] *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*[28] and *Re MDA Investment Management Ltd*.[29]

Uncertainties surrounding the duty

Direct or indirect duty?

Perhaps the most important area of uncertainty has been the question of whether the duty is an independent one owed directly to creditors, with the result that any creditor can take steps to enforce it against the directors, or whether it is an indirect one owed to the company to take account of the creditors' interests, with the result that it can only be enforced by the company.[30]

The preponderance of authority favours the latter interpretation. In *Walker v Wimborne*[31] itself, the duty was expressed as one owed to the company[32] and this approach is reflected either expressly or impliedly in all but one of the British cases referred to above. The exception is *Winkworth v Edward Baron Development Co Ltd*,[33] where Lord Templeman stated that a duty is owed by the directors *to the company and to the creditors of the company* to ensure that the company's affairs were properly administered and that its property was not dissipated or exploited for the benefit of the directors themselves to the prejudice of creditors.[34] This can be interpreted as implying that there is a specific, separate duty to the creditors.[35] As indicated, however, this is inconsistent with the approach taken in the other British cases, and indeed the concept of a direct duty to creditors was specifically rejected in the later case of *Yukong Lines of Korea v Rendsberg Investment Corp of Liberia (No 2)*,[36] where Toulson J said that a director does not owe a direct fiduciary duty to an

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[21] (1987) 1 All ER 114.
[22] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[23] [1990] BCC 600.
[24] [1998] BCC 870.
[25] [1998] 1 BCLC 218.
[26] 2002 SLT 109.
[27] [2002] 1 BCLC 266.
[28] [2002] EWHC 2748.
[29] [2003] EWHC 227. For a discussion of some of these more recent cases, see A Keay, 'Directors Taking Into Account Creditors Interests' 2003 Co. Law 300 and 'Another Way of Skinning A Cat: Enforcing Directors' Duties For The Benefit Of Creditors' 2004 Insolv. Int. 1.
[30] Or, in practice, the company's liquidator, administrator or receiver.
[31] (1976) 137 CLR 1.
[32] See above.
[33] (1987) 1 All ER 114.
[34] *Ibid* at 118 (emphasis supplied).
[35] See V Finch, *Corporate Insolvency Law: Perspectives and Principles* at p 500.
[36] [1998] BCC 870.

individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company.[37]

It should be noted that neither approach is wholly free from difficulty. Potential problems which have been suggested with formulating the duty as an indirect one owed to the company include whether the interests of creditors are to be considered independently or only in so far as they are relevant to the company's interests; whether creditors' interests are part of a "package" of claims including shareholders and employees and, if so, how any conflicts of interests should be resolved; and whether directorial consideration of creditors' interests is to be assessed subjectively or objectively.[38] These issues are discussed further below. However, formulating the duty as a direct one enforceable by individual creditors may be even more problematic, in spite of some apparent advantages. Thus it has been said that while a direct duty might appear to have the advantages of rendering the duty more effective by placing enforcement in the hands of those with the keenest interest in enforcement and of directing the proceeds of a successful action to the particular creditor taking the action, in fact it is questionable to what extent these advantages would actually materialise, and allowing a direct action would invite a multiplicity of actions, encourage litigation and incur considerable time and expense, all of which would be lessened if the company were the only possible litigant.[39] It has also been said that allowing a direct action by creditors would create the potential for double recovery, and that mediating the duty through the company has the advantage of preserving that important principle of insolvency law, the *pari passu* principle, by preventing any one creditor from stealing a march on other creditors as well as preserving the procedural monopoly of liquidation proceedings for dealing with the claims of creditors against an insolvent company.[40] It has further been said that if one accepts the neo-classical view of the company as dedicated to profit maximisation, with the directors as agents of that profit maximisation, a direct duty to creditors cuts across this, and that a direct duty to creditors does not sit easily alongside the board's existing fiduciary duties.[41] The question of the nature of a direct duty, i.e. whether it should be regarded as an extension of the directors' duty of care or as grounded in tortuous principles, has also been raised.[42]

Who are the creditors?

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[37] *Ibid* at 884.

[38] V Finch, *Corporate Insolvency Law: Perspectives and Principles* at p 501. See also R Grantham, ‘The Judicial Extension of Directors’ Duties to Creditors’ 1991 JBL 1.

[39] See C Riley, ‘Directors’ Duties and the Interests of Creditors’ 1989 Co. Law 87. The question of enforcement is discussed further below.

[40] See D Prentice, ‘Creditor’s Interests and Director’s Duties’ 1990 OJLS 265 and ‘Directors, Creditors, and Shareholders’ in McKendrick (ed) *Commercial Aspects of Trusts and Fiduciary Obligations*. Similar points are made in V Finch, ‘Directors’ Duties: Insolvency and the Unsecured Creditor’ in A Clarke (ed) *Current Issues in Insolvency Law*. In relation to the last point, it should be noted that even if the duty is mediated through the company, it may in fact fall to be enforced otherwise than on a liquidation, for example on administration or on the appointment of a receiver.

[41] R Grantham, ‘The Judicial Extension of Directors’ Duties to Creditors’ 1991 JBL 1.

[42] See, for example, V Finch, *Corporate Insolvency Law: Perspectives and Principles* at 499. It should also be noted in this context that it has been pointed out that the remedies for a breach of the directors' fiduciary duty differ to some extent from the remedies for a breach of the director's duty of care with important practical implications: see A Berg, 'The Company Law Review: Legislating Directors' Duties' [2000] JBL 472.

The duty is usually expressed in the most general of terms as a duty to (take account of the interests of) the creditors, but which creditors? One issue here is whether the duty is confined to existing creditors or extends to future creditors. Most of the cases are silent on the matter, but in *Winkworth v Edward Baron Development Co Ltd*,[43] Lord Templeman clearly included future creditors. In contrast, in *Brady v Brady*,[44] Nourse J confined his formulation of the duty to existing creditors and in *Nicholson v Permakraft*,[45] Cooke J took the view that future creditors would normally take the company as it was and could look after their own interests. The latter approach has, however, been criticised on the basis that, at least once the company has reached the stage where insolvent liquidation is inevitable, there is little justification for differentiating between the two groups of creditors.[46]

The issue is important because the interests of present and future creditors may conflict.[47] So too may the interests of existing creditors: a number of commentators have pointed out that creditors are not a homogenous group and may have conflicting interests and that there is little guidance for directors who have to choose between competing interests.[48] Some further guidance can now be found in the recent decision in *Re Pantone 485 Ltd*,[49] where Richard Field QC stated that the creditors meant the creditors as a whole, i.e. the general creditors, and that if the directors acted consistently with the interests of the general creditors but inconsistently with the interest of a creditor or section of creditors with special rights in a winding up, they would not be in breach of their duty to the company.[50] This still leaves a number of questions unanswered, however, for example what precisely is meant by 'general creditors' and 'creditors with special rights in a winding up'.

Which creditors *should* benefit from any such duty? Finch has argued that the duty should be construed as being owed to the unsecured creditors as a class, and that this would give meaningful guidance to directors without being prejudicial to secured creditors who would still be able to take steps to enforce their security.[51] *Re Pantone 485 Ltd*[52] *may* have this result *if* 'general creditors' can be regarded as unsecured creditors and 'creditors with special rights in an insolvency' (whose interests must give way to the interests of the general creditors) can be regarded as including secured

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[43] (1987) 1 All ER 114.
[44] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[45] [1985] 1 NZLR 242.
[46] C Riley, 'Directors' Duties and the Interests of Creditors' 1989 Co. Law 87 at 90. For a contrary view, see R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' 1991 JBL 1. The issue of insolvency is discussed further below.
[47] Finch gives as an example a decision to go into administration which may reap economic and social dividends in the future but may involve existing debts being frozen, subordinated or written off: see V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in A Clarke (ed) *Current Issues in Insolvency Law* and *Corporate Insolvency Law* at 103.
[48] See, for example, C Riley, 'Directors' Duties and the Interests of Creditors' 1989 Co. Law 87; V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in A Clarke (ed) *Current Issues in Insolvency Law* and *Corporate Insolvency Law: Perspectives and Principles* at p 501-2.
[49] [2002] 1 BCLC 266.
[50] *Ibid* at 286-7. In that case, the creditor in question was a preferential creditor. See also *Re MDA Investment Management Ltd* [2003] EWHC 227, where Park J also referred to the interests of the company's creditors *as a whole*, although with elaborating on that concept.
[51] See V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in A Clarke (ed) *Current Issues in Insolvency Law* and *Corporate Insolvency Law*: *Perspectives and Principles* at p 502.
[52] [2002] 1 BCLC 266.

creditors, but this is not entirely clear. A more sophisticated formulation suggested by Lipson is that the duty should be owed only to those creditors with low levels of volition, cognition and exit, namely tort creditors, certain terminated employees, taxing authorities and certain trade creditors.[53] As he himself acknowledges, however, such an approach has a number of implications which may require further consideration. Whatever approach is taken, however, it is arguable that some distinction must be made in order to ensure that the duty is capable of operating effectively.[54]

Are creditors' interests entitled to exclusive consideration?

There is a lack of consistency in the case law as to whether the directors must consider the interests of creditors exclusively when the duty arises or whether, and to what extent, they can take other interests into account. The question of when the duty arises is considered in more detail below, but it requires to be mentioned briefly here because the circumstances in which the duty arises are relevant to assessing the weight to be given to creditors' interests at that point and this is also discussed further below. At this point, it should suffice to say that the duty is generally regarded as arising when the company is either insolvent or in some degree of financial distress or where a proposed course of action is likely to render the company insolvent.

Some of the cases are silent or ambiguous on this issue, while others are clearer but point in contrary directions. In *Brady v Brady*,[55] for example, Nourse J said that where the company is insolvent or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone. This clearly suggests an exclusive focus on creditor interests. Finch suggests that such an approach is consistent with the approach of Street J in *Kinsela v Russell Kinsela Pty Ltd*,[56] referred to above, to the effect that where a company is insolvent, it is in a practical sense the creditors' assets which are being managed by the directors.[57] However, it is suggested that the comments of Street J are not in fact entirely unambiguous in this respect; as noted above, these comments were approved, without elaboration, by Dillon LJ in *West Mercia Safety Wear Ltd v Dodd*,[58] but the latter case has been cited in subsequent cases as authority both for the proposition that the creditors' interests become paramount in an insolvency situation[59] and for the proposition that the creditors' interests in an insolvency situation require to be taken into account in addition to the interests of shareholders.[60] In *Re Pantone 485 Ltd*,[61] Richard Field QC also said that it was firmly established that when a company becomes insolvent, the directors must act in the interests of its creditors and not its shareholders, again suggesting an exclusive

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[53] J C Lipson, 'Directors' Duties To Creditors: Power Imbalance And The Financially Distressed Corporation' (2003) 50 UCLA Law Review 1189.
[54] See, for example, V Finch, *Corporate Insolvency Law*: *Perspectives and Principles* at p 502.
[55] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[56] (1986) 4 NSWLR 722.
[57] V Finch, *Corporate Insolvency Law*: *Perspectives and Principles* at p 503.
[58] (1988) BCLC 250.
[59] See *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 where the decision in *Brady v Brady* (1988) BCLC 20 was also cited in support of the proposition.
[60] See, for example, *Clydebank Football Club Ltd v Steedman and ors* 2002 SLT 109 and *Re MDA Investment Management Ltd* [2003] EWHC 227.
[61] [2002] 1 BCLC 266.

focus on creditor interests, and cited as authority for this proposition *Re Horsley and Weight Ltd*,[62] but it is doubtful whether the latter case can be said to support such a sweeping statement. The statement of Nourse J in *Brady v Brady*[63] is clear and unambiguous, but it is the only such clear and unambiguous statement to be found in the British authorities.

In contrast, many of the other cases which touch on the matter seem to favour an approach where creditors' interests are considered alongside other interests, particularly the interests of the shareholders. Thus in *Walker v Wimborne*[64] itself, Mason J spoke of the need for directors to take into account the interests of shareholders *and* creditors, although he did not limit the duty to cases of insolvency or financial distress. In *Nicholson v Permakraft*,[65] Cooke J spoke of the need for the directors on the facts of particular cases to consider, *inter alia*, the interests of creditors and said that in his opinion, creditors were entitled to consideration in what is here described loosely as various circumstances related to insolvency.[66] There is nothing to suggest, however, that creditors' interests should be considered exclusively in those circumstances. In *Lohnro Ltd v Shell Petroleum Co Ltd*,[67] as noted above, Lord Diplock stated that the best interests of the company, in which the directors were bound to act, were not exclusively those of the shareholders but might include those of its creditors, thus clearly requiring the directors to take account of both, although again the duty was not limited to cases of insolvency or financial distress. In both *Clydebank Football Club Ltd v Steedman and ors*[68] and *Re MDA Investment Management Ltd*,[69] the matter was approached on the basis that the interests of creditors had to be taken into account as well as the interests of shareholders where the company was insolvent or in financial difficulty. Finally, it should be noted that in *Re Welfab Engineers Ltd*,[70] Hoffmann J (as he was then) held that the directors were entitled to take into account, *inter alia*, the interests of employees when considering various offers for the company's business although they were not entitled to sell the business to save their jobs and those of the other employees of the company on terms which would clearly leave the creditors in a worse position than on liquidation.

Finch suggests that a way to resolve the tensions in this area is to read the *dicta* in *Brady v Brady*[71] and *Kinsela v Russell Kinsela Pty Ltd*[72] as being concerned with the reorientation of focus from shareholder to creditor interests occurring around the point of insolvency rather than as concerned with the issue of exclusivity of interests and for the courts to stress that while creditor interests do fall to be considered on insolvency or financial distress, they do not have to be the exclusive concern of directors, in the same way as directors are entitled to look beyond shareholder

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[62] (1982) 3 All ER 1045.
[63] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[64] (1976) 137 CLR 1.
[65] [1985] 1 NZLR 242.
[66] These are considered in greater detail below.
[67] [1980] 1 W.L.R. 627.
[68] 2002 SLT 109.
[69] [2003] EWHC 227.
[70] [1990] BCC 600.
[71] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[72] (1986) 4 NSWLR 722.

interests before insolvency.[73] Such an inclusive approach would sit well with the recent emphasis in Great Britain on a more inclusive approach to the concept of the company generally,[74] but as noted above in relation to creditors with conflicting interests, there are problems with an approach which requires directors to consider conflicting interests.[75]

Is the test subjective or objective?

As noted above, one of the problems identified with regarding the duty as one owed to the company is whether directorial consideration of creditors' interests is to be assessed subjectively or objectively.[76] The answer to this question is uncertain.[77] Finch points out that a subjective approach would be consistent with principle but poses problems of accountability while an objective approach could draw the courts into an assessment of directors' business decisions.[78] This issue is discussed further below in the context of assessing the directors' knowledge of the circumstances which trigger the duty.

When does the duty arise?

Another important area of uncertainty is precisely when the duty arises. Some of the early cases, including *Walker v Wimborne*[79] itself, *Lohnro Ltd v Shell Petroleum Co Ltd*[80] and *Winkworth v Edward Baron Development Co Ltd*[81] do not make any reference to a requirement for the company to be insolvent or in financial distress in order for the duty to arise. However, in another of the early cases, *Re Horsley and Weight Ltd*,[82] Templeman LJ (as he was then) said that misfeasance on the part of the directors would have been established if the company had been 'doubtfully solvent' at the relevant time and the later cases have generally conditioned the existence of the duty on the company's insolvency or certain circumstances short of insolvency. Thus while insolvency or certain circumstances short of insolvency now seems to be an accepted requirement for the duty to arise, uncertainty remains over the precise point at which it does so because of the different terminology used by the judges.

Thus, in *West Mercia Safety Wear Ltd v Dodd*,[83] as noted above, Dillon LJ contrasted the position in the earlier case of *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd and ors*[84] where the company was 'amply solvent' with the position in the instant case where the company was 'insolvent' and quoted with approval the dictum of Street J in *Kinsela v Russell Kinsela Pty Ltd*[85]

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[73] V Finch, *Corporate Insolvency Law*: *Perspectives and Principles* at p 503.
[74] See, for example, the Company Law Review Steering Group, discussed further below.
[75] For a more detailed discussion, see in particular C Riley, 'Directors' Duties and the Interests of Creditors' 1989 Co. Law 87.
[76] V Finch, *Corporate Insolvency Law: Perspectives and Principles* at p 501.
[77] For a detailed discussion, see Feldman and Meisel (eds) *Corporate and Commercial Law: Modern Developments*, Chapter 9, p 189.
[78] *Ibid*.
[79] (1976) 137 CLR 1.
[80] [1980] 1 W.L.R. 627.
[81] (1987) 1 All ER 114.
[82] (1982) 3 All ER 1045.
[83] (1988) BCLC 250.
[84] (1983) 2 All ER 563.
[85] (1986) 4 NSWLR 722.

to the effect that the duty arises where a company is insolvent.[86] In *Brady v Brady*,[87] as noted above, Nourse J said that the interests of the company were in reality the interests of existing creditors alone where the company was 'insolvent, or even doubtfully solvent'. In that case, the company in fact remained solvent following the transaction which was said to give rise to the breach of duty, but Nourse J went on to say that the proportion of assets being removed from the company (one half) required the directors to ask themselves whether the remaining half would be sufficient to discharge the company's existing debts, which implies that directors are also required to consider the interests of creditors where the company is solvent but a transaction potentially affects that solvency. This echoes the approach taken in *Nicholson v Permakraft*,[88] where Cooke J said that in his opinion, creditors were entitled to consideration when the company was 'insolvent, or near insolvent, or of doubtful solvency, or if a contemplated payment or other cause of action would jeopardise its solvency'.[89] In *Facia Footwear Ltd v Hinchcliffe*,[90] Sir Richard Scott V-C, having quoted the familiar passages from *Walker v Wimborne*,[91] *Nicholson v Permakraft*[92]and *Kinsela v Russell Kinsela Pty Ltd*,[93] went on to say that the duty arose in the instant case since the company and the whole group of which it was part were in 'a very dangerous financial position'. In *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*,[94] the duty was expressed as arising where the company was 'insolvent or of doubtful solvency or on the verge of insolvency and it is the creditors' money which is at risk'[95] while in *Re MDA Investment Management Ltd*,[96] Park J said that the duty arose where the company 'whether technically insolvent or not, is in financial difficulties to the extent that its creditors are at risk'.[97]

It is clear from these *dicta* that 'insolvency' will trigger the duty and most of the cases contemplate that the duty will also be triggered in certain circumstances short of insolvency. It is, however, difficult to identify with precision what such circumstances are and even the concept of insolvency itself as a trigger for the duty is not unproblematic. Insolvency is not a term of art and may be used to mean different things, for example, balance sheet insolvency (where liabilities exceed assets), practical/liquidity insolvency (where the company is unable to pay its debts as they fall due).[98] None of the British cases, however, attempts to define what is meant by insolvency in this context and the vagueness of the concept as a basis for directors'

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[86] In *Kinsela v Russell Kinsela Pty Ltd* itself, the question of whether the duty would arise in circumstances short of insolvency was left open. Of course, insolvency itself may have more than one meaning – this is discussed further below.
[87] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[88] [1985] 1 NZLR 242.
[89] *Ibid* at 249.
[90] [1998] 1 BCLC 218.
[91] (1976) 137 CLR 1.
[92] [1985] 1 NZLR 242.
[93] (1986) 4 NSWLR 722.
[94] [2002] EWHC 2748.
[95] *Ibid* at para [74].
[96] [2003] EWHC 227.
[97] [2003] EWHC 227 at para [70].
[98] Both of these concepts are encompassed by the statutory test for insolvency in s 123 of the Insolvency Act 1986. Insolvency can be defined in other ways for other purposes: see, for example, the test for wrongful trading in s 214 of the Insolvency Act 1986.

duty has been criticised.[99] It has also been pointed out that there can be real practical difficulties in identifying the point at which a company has become insolvent, irrespective of which test is used,[100] and it is not clear whether the directors' knowledge of the insolvency is to be judged objectively or subjectively.[101] Furthermore, it has been said that the point at which the company becomes insolvent is too late for the duty to creditors to arise.[102] To focus on problems with the concept of insolvency as a trigger for the duty, however, may be to miss the point. Grantham points out that insolvency is simply the most obvious indicator of the fact that the residual risk is no longer borne by the shareholders and thus the question to be asked by the court is not simply whether the company is insolvent but, given the distribution of risk, whether it is still appropriate to regard the interests of the shareholders as exclusively reflecting the corporate interest.[103] In other words, the critical issue is not the company's solvency or insolvency as such, but whether the circumstances are such as to put the creditors' interests at risk so that a shift in directors' duties to taking creditors' interests into account (exclusively or otherwise[104]) is justified. Such an approach is consistent with the requirement in *Nicholson v Permakraft*[105] and *Brady v Brady*[106] that creditors' interests be considered even where the company is solvent if a contemplated payment or other action would jeopardise that solvency and is clearly reflected in *dicta* such as those in *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*[107] and *Re MDA Investment Management Ltd*[108] referred to above, which focus on the risk to the creditors.

Keay has suggested that the most appropriate formula for the trigger for the duty would be where the circumstances of the company are such that that its directors know, or can reasonably expect, that the action upon which they are going to embark could lead to the insolvency of the company.[109] This test is an objective one and he argues that if such a formulation were adopted, the court would require to take into account the particular circumstances in each case so that the more obvious it is that the creditors' money is at risk, the lower the risk to which the directors' are justified in exposing the company.[110] The Company Law Review Steering Group, in formulating a possible statutory version of the duty, provided for it to arise when a director knows, or would know but for a failure of his to exercise due care and skill, that it is more likely than not that the company will at some point be unable to pay its debts as they

[99] For more detailed discussion on this issue, see R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' 1991 JBL 1 and A Keay, 'The Director's Duty To Take Into Account The Interests Of Company Creditors: When Is It Triggered? [2001] MULR 11.
[100] See in particular A Keay, *ibid*; V Finch, 'Directors' Duties Towards Creditors' 1989 Co. Law 23 and *Corporate Insolvency Law: Perspectives and Principles* at 506.
[101] See in particular A Keay, *ibid*; V Finch, *Corporate Insolvency Law: Perspectives and Principles* at 506-7. Finch suggests that the test requires to be an objective one if creditors' interests are to be adequately protected.
[102] A Keay, *ibid*.
[103] R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' 1991 JBL 1.
[104] See above.
[105] [1985] 1 NZLR 242.
[106] (1988) BCLC 20. The decision was reversed on the facts in the House of Lords, but nothing that was said there detracted from the Court of Appeal's recognition of the duty.
[107] [2002] EWHC 2748.
[108] [2003] EWHC 227.
[109] A Keay, 'The Director's Duty To Take Into Account The Interests Of Company Creditors: When Is It Triggered? [2001] MULR 11.
[110] *Ibid*.

fall due. The proposals of the Company Law Review Steering Group are discussed in more detail below, but it may be noted that this test is also an objective one and it includes a definition of insolvency. Both of these formulations continue to link the duty to the concept of insolvency. In view of the previous discussion, however, it may be that a formula which instead refers to the risk to (relevant) creditors' interests would reflect the real focus of the duty more clearly, for example where the directors know or ought to have known that their conduct would put the (relevant) creditors' interests at risk.

The Company Law Review

As noted above, the Company Law Review Steering Group was set up by the government to review core company law in 1998[111] and reported in 2001.[112] Directors' duties was one of the main areas considered by the review. At the time the Company Law Review Steering Group was set up, the issue of regulating directors' conflicts of interests and formulating a statement of directors' duties was already under consideration by the Law Commissions,[113] but it was intended that the Company Law Review would look at the wider issue of whether the directors' duty to act in the interests of their companies should be interpreted as meaning simply that they should act in the interests of the shareholders or whether they should take account of other interests, such as those of employees, creditors, customers, the environment and the wider community.[114]

The Company Law Review Steering Group published its first consultation document by in February 1999.[115] This considered directors' duties as part of the wider issue of the proper scope of company law i.e. in whose interests companies should be run. It noted that under the current legal framework, companies are formed and managed for the benefit of shareholders but subject to safeguards for the benefit of actual and prospective creditors.[116] It also noted that directors are obliged by their fiduciary duties to manage the business on behalf of the shareholders honestly, in their best judgement, for the benefit of the company, which normally means for the benefit of the shareholders as a whole,[117] but that there is an overriding obligation to ensure that creditors are not wrongfully exposed to insolvency through the general duties imposed by company law (citing *West Mercia Safety Wear Ltd v Dodd*[118]) and insolvency law and the special safeguards which apply to protect creditors in particular transactions such as distributions of profits or capital.[119]

The first consultation document considered two main approaches to the question of the proper scope of company law: the 'enlightened shareholder value' approach, which regards the interests of the company as the interests of the shareholders but recognises

[111] See *Modern Company Law for a Competitive Economy* (March 1998).
[112] *Modern Company Law for a Competitive Economy: Final Report* (July 2001).
[113] See the joint consultation paper by the Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts Of Interests And Formulating A Statement of Duties* (1998) (Consultation Paper No 153; Discussion Paper No 105).
[114] *Modern Company Law for a Competitive Economy*, para 3.7.
[115] *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999).
[116] *Ibid* at para 5.1.4.
[117] *Ibid* at para 5.1.5.
[118] (1988) BCLC 250.
[119] *Ibid* at para 5.1.5, 5.1.6.

that promoting the interests of the shareholders will involve giving appropriate consideration to other interests, and the 'pluralist' approach, which seeks to redefine the interests of the company in such a way that that concept encompasses a number of different interests, not just shareholders. It recognised that each of these approaches would require a different formulation of directors' duties and sought views on various possible options.[120] It did not mention further, however, the directors' duty to creditors where the company is financially distressed.

Later that year, the Law Commissions published their Report on Regulating Conflicts Of Interests And Formulating A Statement Of Duties.[121] They recommended, *inter alia*, a partial codification of the law on directors' duties and produced a draft statutory statement of the main duties owed by a director to his company. The draft statement encompassed the main fiduciary duties and the duty of care and skill but stressed that it was not a complete statement of a director's duties. The directors' duty to creditors where the company is financially distressed was not included in the draft statement, although its existence had been noted in the joint consultation paper.[122]

The Company Law Review Steering Group published a further consultation document in March 2000.[123] This effectively adopted the enlightened shareholder value approach to company law which had been favoured by the majority of consultees.[124] So far as directors' duties were concerned, the consultation document proposed, *inter alia*, to introduce a statutory statement of principles covering all directors' general duties which would include a requirement for directors to achieve the success of the company for the benefit of the shareholders by taking proper account of all relevant considerations for that purpose[125] and included a trial draft statutory statement.[126] The first principle in the trial draft set out what it described as the directors' duty of compliance and loyalty. It required a director to exercise his powers honestly and for their proper purpose and in accordance with the company's constitution and decisions taken lawfully under it and, subject to that requirement, to exercise his powers in the way he believes in good faith is best calculated in the circumstances, taking account of both the short and the long term consequences of his acts, to promote the success of the company for the benefits of its members as a whole. It went on to state that the circumstances to which the director is to have regard for that purpose include, in particular, so far as his duty of skill and care may require, the company's need to foster its business relationships, including those with its employees and suppliers and customers; the impact of its operations on the environment; and its need to maintain a reputation for high standards of business conduct.

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[120] *Ibid* at para 5.1.10.

[121] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts Of Interests And Formulating A Statement of Duties* (1999) (Law Com No 261; Scot Law Com No 173).

[122] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts Of Interests And Formulating A Statement of Duties* (1998) (Consultation Paper No 153; Discussion Paper No 105), para 11.22-11.23. See also para 11.39, which deals with the issue of ratification where the company is or may become insolvent.

[123] *Modern Company Law for a Competitive Economy: Developing the Framework* (2000).

[124] *Ibid*, para 2.11.

[125] *Ibid*, para 2.19.

[126] *Ibid* at para 3.40. The trial draft was based on, but was in many respects quite different from, the draft statement produced by the Law Commissions.

The commentary on the trial draft stated that it was intended to retain the current relationship between the general duties of directors and the rest of the law which meant, for example, that insolvency law and the liabilities of directors for misfeasance in an insolvent winding up would be retained in their present overriding form.[127] Consideration was given to the inclusion of an additional principle specifically requiring directors 'to consider foremost the interests of creditors in circumstances where the company is insolvent or threatened by insolvency'.[128] It was said that while a number of British and Commonwealth cases suggested that such a principle existed (giving as examples *Nicholson v Permakraft*[129] and *West Mercia Safety Wear Ltd v Dodd*[130]), 'in reality the cases seem capable of resolution on the basis of other principles and have been strongly criticised on these grounds.'[131] It was also said that creditors should have a remedy in a winding up or on the basis of their contracts and that the prospect of personal liability under insolvency law should have a deterrent effect on directors when a company is threatened with insolvency.[132] It was said further that creditors' interests were already properly included within the inclusive loyalty principle[133] and that enactment of an additional principle would cut across section 214 of the Insolvency Act 1986 which enables the liquidator in an insolvent winding up to recover a contribution from a director who failed to take the necessary action to protect creditors where insolvency was inevitable, a separate and detailed overriding provision which there was no reason to change.[134] The inclusion of the additional principle in the statement was therefore rejected.[135] It was thought, however, that the position with respect to ratification might be different,[136] and views were sought on whether a specific provision, effectively preserving the current law, should be enacted to the effect that misfeasance by directors cannot lawfully be ratified if it takes place when solvency is in doubt and the effect would be to deprive creditors of relief in an insolvent winding up.[137] Views were also sought on whether it would be appropriate to include in Form 288 (consent to act as a director) a separate warning that special principles become relevant where a company is threatened by insolvency.[138] What 'special principles' were meant was not specified and it was not therefore clear whether this was a reference (only) to insolvency law principles such as those contained in section 214 of the Insolvency Act 1986 or included the common law duty to creditors; it was not entirely clear whether that duty was intended to survive notwithstanding the decision not to include it in the statement of duties.

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[127] *Ibid* at para 3. *Ibid* at para 3.7242.
[128] *Ibid* at para 3.72.
[129] [1985] 1 NZLR 242.
[130] (1988) BCLC 250.
[131]. This is the view taken by Sealy: see L Sealy 'Directors' Duties - An Unnecessary Gloss' [1988] CLJ 175 and 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law*.
[132] *Modern Company Law for a Competitive Economy: Developing the Framework*, para 3.72.
[133] Described above. In fact creditors are not specifically mentioned, but then the list is not meant to be exhaustive.
[134] *Modern Company Law for a Competitive Economy: Developing the Framework*, para 3.72. Section 214 of the Insolvency Act and its relationship with the duty are discussed further below.
[135] *Ibid* at para 3.73.
[136] *Ibid*.
[137] *Ibid*, para 3.81.
[138] *Ibid*, para 3.73.

The next consultation document, published in November 2000,[139] dealt with the duty to creditors only very briefly. It said:[140]

> It is generally agreed that the duties [contained in the statement] must be subject to the overriding duties of directors towards creditors in an insolvency situation, but also that it is undesirable to lay down any detailed new rule in this area; the law is developing and there is already a carefully balanced statutory provision, which operates *ex post* in a liquidation, in the Insolvency Act 1986 section 214 (wrongful trading). We propose that this issue should be dealt with in a general provision in the statement making it clear that the duties operate subject to the other provisions of the Act and to the supervening obligations to have regard to the interests of creditors when the company is insolvent or threatened by insolvency.

When the final report of the Company Law Steering Group was published in 2001,[141] however, the revised statement of directors' duties which it contained did include provisions on the duties of directors to have regard to the interests of creditors where there is a risk of insolvency and the reasons for this were explained in some detail.[142] It was said that it was important to draw to the attention of directors the fact that different factors might need to be taken into consideration where the company is insolvent or threatened by insolvency and to fail to do so would risk misleading directors by omitting an important part of the overall picture.[143] It was also said that it was felt the earlier technical problems and concerns about including the duty could be resolved.[144]

The key issue for the Company Law Steering Group was when the normal rule that a company should be run in the interests of its shareholders should be modified by an obligation to have regard also to the interests of creditors or, in an extreme case, an obligation to override the interests of shareholders entirely.[145] It observed that there is always some risk that insolvency may occur unexpectedly, but as insolvency becomes more imminent, the normal synergy between the interests of members and creditors progressively disappears and as the margin of assets reduces, so does the incentive on directors to avoid risky strategies which endanger the assets.[146] It noted that the present law provided two solutions to this problem. The first solution was section 214 of the Insolvency Act 1986, in terms of which the directors are liable to make a contribution towards the company's assets in an insolvent liquidation where they knew or ought to have known that the company had no reasonable prospect of avoiding insolvent liquidation and failed to take all reasonable steps to minimise the loss to creditors.[147] It was proposed that this rule should be included in the statement of directors' duties in order to make clear the point at which the normal duty of loyalty

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[139] *Modern Company Law for a Competitive Economy: Completing the Structure* (2000).
[140] *Ibid*, para 3.12.
[141] *Modern Company Law for a Competitive Economy: Final Report* (July 2001).
[142] See *ibid*, para 3.11.
[143] *Ibid*, para 3.12.
[144] *Ibid*, paras 3.12, 3.13.
[145] *Ibid*, para 3.14.
[146] *Ibid*, para 3.15.
[147] *Ibid*, para 3.16. It should be noted that the section in fact requires the directors to have taken 'every step' to minimise the loss to creditors, which is a somewhat different thing. Section 214 is discussed further below.

is displaced[148] and an appropriate provision was included in the statement of directors' duties included in the report.

The second solution was the duty to take into account the interests of creditors at an earlier stage in the onset of insolvency recognised in case law.[149] The Company Law Steering Group suggested that this principle would require directors, where they knew or ought to recognise that there was a substantial probability of an insolvent liquidation, to take such steps as they believed, in good faith, appropriate to reduce the risk, without undue caution and thus continuing also to have in mind the interests of members.[150] It added that the greater the risk of insolvency in terms of probability and extent, the more directors should take account of creditors' needs and the less those of members; at the point where there was no reasonable prospect of avoiding insolvent liquidation, the interests of creditors would become overriding under the first (section 214) test.[151] Leaving aside the question of whether that is what the duty as currently formulated would in fact require, the Company Law Review Steering Group thought that such a rule might be regarded as of considerable merit, at least in principle,[152] and it considered what it saw as the arguments for and against such a rule. In favour of the rule was the argument that without it, directors would apparently be bound to act in the ultimate interests of members until all reasonable prospect of avoiding shipwreck had been lost but, where insolvency was less than inevitable yet the risk was substantial, directors should consider the interests of creditors and members together.[153] Against it was the argument that it might a 'chilling effect' and the risk that the directors might run down or abandon a going concern at the first hint of insolvency.[154] It was recognised that the balanced judgement the rule would require was a difficult and indeterminate one and that fear of personal liability might lead to excessive caution.[155] It was said that the fact that case law already imposed such a duty was not a sufficient reason for retaining it if it would lead to the failure of viable businesses.[156] It was thought, however, that the concerns could at least to some extent be met by careful drafting, by making the judgement required subject to a subjective rather than an objective test and by providing, as already mentioned above, that the duty would only arise when the directors ought in the exercise of due care and skill to recognise that a failure to meet the company's liabilities is more probable than not.[157] It was also noted that where the business is threatened with insolvency, there are procedures short of liquidation open to directors which both provide protection for creditors and preserve the business.[158] The Company Law Steering Group were, however, split on whether (a version of) the common law rule should be included in the statement of directors' duties.[159] Those against the inclusion of the rule felt that

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[148] *Ibid*, para 3.16.
[149] *Ibid*, para 3.17.
[150] *Ibid*.
[151] *Ibid*.
[152] *Ibid*, para 3.18.
[153] *Ibid*.
[154] *Ibid*, para 3.19.
[155] *Ibid*.
[156] *Ibid*, para 3.20.
[157] *Ibid*, para 3.20.
[158] *Ibid*. There are two main rescue-oriented procedures in the Insolvency Act 1986, company voluntary arrangements and administration. Other options include a compromise or arrangement under section 425 of the Companies Act 1985.
[159] *Modern Company Law for a Competitive Economy: Final Report*, para 3.20.

even with careful drafting, there would not be adequate guidance for directors and liability would depend on their being able to discern an intermediate stage on the path to insolvency which is not identifiable in reality.[160] A draft provision was included in the statement of directors' duties to reflect the views of those members who thought it should be included, and it was recommended that further consultation should take place.[161]

It is worth setting out that draft provision in full:

> At a time when a director of a company knows, or would know but for a failure of his to exercise due care and skill, that it is more likely than not that the company will at some point be unable to pay its debts as they fall due-
>
> (a) the duty under paragraph 2 does not apply to him; and
>
> (b) he must, in the exercise of his powers, take such steps (excluding anything which would breach his duty under paragraph 1 or 5) as he believes will achieve a reasonable balance between-
>
> (i) reducing the risk that the company will be unable to pay its debts as they fall due; and
> (ii) promoting the success of the company for the benefit of its members as a whole
>
> **Notes**
>
> (1) What is a reasonable balance between those things at any time must be decided in good faith by the director, but he must give more or less weight to the need to reduce the risk according as the risk is more or less severe.
> (2) In deciding in any case what would be most likely to promote the success of the company for the benefit of its members as a whole, the director must take into account in good faith all the material factors that it is practicable in the circumstances for him to identify
> (3) The notes to paragraph 2 also apply also for the purposes of this paragraph
> (4) In this paragraph, "due care and skill" means the care, skill and diligence required by paragraph 4.

(The duty under paragraph 2 is a revised duty to promote the company's interests for the benefit of its members as a whole, while the duties under paragraphs 1 and 5 are a revised duty to obey the constitution and other lawful decisions and a revised rule on conflicts of interests respectively; the revised duties under paragraphs 1 and 2 and the notes to paragraph 2 are derived from the composite first principle in the trial draft contained in the March 2000 consultation paper discussed above. The statement of duties was subject to revision throughout the consultation process.)

The draft provision certainly addressed many of the uncertainties in the present law, although there might be differing views on whether the ways in which it did so were appropriate. Thus, it provided that the duty is owed to the company and thereby addressed any remaining uncertainty regarding this in the present law. It provided for the duty to apply when it is more likely than not that the company will at some point

[160] *Ibid*.
[161] *Ibid*.

be unable to pay its debts, a concept which is defined in the Insolvency Act 1986[162] and includes both balance sheet and practical/liquidity insolvency, and thus addressed the uncertainty as to the point at which the duty arises in the present law, although the practical problems in identifying that the relevant point has in fact been reached will, as concerned those arguing against the duty, remain. It provided that the test for identifying whether the relevant point has been reached is an objective one while the test for complying with the duty itself is subjective and thus addressed the uncertainties as to these issues in the present law. It provided for creditors' interests to be considered alongside the interests of the shareholders and any other relevant interests, with more weight being given to creditors' interests as the risk of insolvency increases up to the point where the creditors' interests become overriding as a result of the duty under section 214 of the Insolvency Act 1986, and thus addressed at least partially the uncertainty as to the extent to which creditors' interests are to be taken into account and the relative weight to be given to the respective interests in the present law, although problems of conflict could remain in practice. It did not, however, address the need to specify which creditors should benefit from the duty or give guidance on the issue of conflicting creditor interests, a serious omission.

The government's response

The government has, however, decided not to include either the proposed provision based on section 214 of the Insolvency Act 1986 or the draft provision based on the common law duty in the statement of directors' duties which is to be included in the forthcoming legislation. In the White Paper *Modernising Company Law* issued in July 2002,[163] it was stated that the government had carefully considered both suggestions but had concluded that the weight of argument was against the inclusion of any duties relating to creditors in the statutory statement.

In relation to the proposed provision based on section 214 of the Insolvency Act 1986, it was said that it would de-couple the obligations imposed under the section from the remedies available under it, it would unhelpfully conflate company and insolvency law and it is only one of many duties and obligations owed by directors apart from company law which it would be inappropriate to single out for inclusion in the statutory statement of duties.[164] It is suggested that the government's reasoning on this point is sound and that there is no need to repeat a duty arising under insolvency law in the general statement of directors' duties.

In relation to the draft provision based on the common law duty, it was said that the arguments against the retention of this provision had been outlined by the Review itself and that the need for directors to make a finely balanced judgement together with the fact that fears of personal liability might lead to excessive caution would run counter to the rescue culture which the government was seeking to promote.[165] As has

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[162] The explanatory notes which accompany the statement of directors' duties make it clear that it is this definition which is to apply.
[163] Cm 5553.
[164] *Ibid*, paras 3.12, 3.13. It was considered that the comprehensive guidance for directors which the government was proposing be prepared would enable directors' attention to be drawn to their additional duties under the insolvency legislation.
[165] *Ibid*, para 3.11.

been pointed out elsewhere,[166] the government's reasoning here is perhaps less sound. Firstly, Keay argues that directors might equally well be cautious as a result of their fear of being held liable for wrongful trading under section 214 of the Insolvency Act 1986 itself,[167] although of course under that provision the duty only arises at a later stage.[168] Secondly, since it is widely accepted that the earlier a rescue process is commenced the more chance there is that it will be successful to the benefit of all concerned, if the duty to consider creditors at an earlier stage had the effect, as it arguably could, of causing the directors to take earlier action to institute a rescue process in appropriate cases, this would in fact benefit rather than run counter to the rescue culture.[169]

The White Paper did offer an alternative approach to the question of creditors, which was to include mention of them, possibly by reference to the company's obligations to them, among the factors to which directors must have regard, where appropriate, in complying with the revised duty to promote the company's interests for the benefit of its members as a whole.[170] It was recognised, however, that this would not achieve the effect which the draft provision was intended to achieve.[171]

The explanatory notes accompanying the statement of directors' duties in the Company Law Steering Group's final report made it clear that if the draft provision was not adopted in some form, consideration would need to be given to whether the common law principle should be repealed or left to develop, which would leave the statement of directors' duties incomplete, although there would be the possibility of including a suitable warning for directors in that event. As noted, the White Paper rejected the draft provision, but it did not specifically address what should be done about the existing common law. However, the draft of the Company Law Reform Bill which is due to be introduced into Parliament shortly makes it clear that the common law will survive. In setting out the (further refined) duty to promote the success of the company for the benefit of its members, a provision has been added stating that that duty is subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.[172] The explanatory material accompanying the draft states that the new provision

> recognises that the normal rule that a company is to be run for the benefit of its members as a whole may need to be modified where the company is insolvent or threatened by insolvency. In doing so, it preserves the current legal position that, when the company is insolvent or is nearing insolvency, the interests of the members should be supplemented or even replaced, by those of its members.

The common law will thus be left to develop as opportunity permits. This may permit more flexibility in developing the duty than a statutory provision would have provided, but it is suggested that since the duty is to be retained, a specific provision in the legislation, providing it was carefully thought through and drafted, would have

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[166] A Keay, 'Directors Taking Into Account Creditors Interests' 2003 Co. Law 300.
[167] *Ibid* at 306.
[168] Arguably too late: this is discussed further below.
[169] Keay makes a similar point in 'Directors Taking Into Account Creditors Interests' 2003 Co. Law 300 at 306.
[170] Cm 5553 at para 3.14.
[171] *Ibid*.
[172] Draft Company Law Reform Bill, section B3(4).

been more satisfactory since it could have resolved at least some of the present uncertainties surrounding the duty, uncertainties which will now have to await clarification by the courts as and when the opportunity arises. However, at least the inclusion of the provision referred to above will draw directors' attention to the fact that they have the duty even if they cannot determine its content with any certainty.

The role of the duty in modern British law

It thus appears that the directors' duty to creditors will remain part of British law. It may be asked, however, whether it has a real role to play.

A role for the duty has been emphatically refuted by Sealy,[173] who has said that the law already gives the courts ample scope to deal with all potential abuses of trust by company directors and even if that had not been so prior to 1986, the (then) new wrongful trading provision in section 214 of the Insolvency Act 1986 would allow for developments on a statutory footing which were properly integrated with insolvency law as a whole.[174] Other commentators, however, have pointed out that this may not in fact be correct and that the duty does have a role to play in supplementing other provisions for the protection of creditors' interests.[175]

There are a variety of provisions for the protection of creditors' interests built into both company and insolvency law, but this paper will concentrate on the main protections to be found in insolvency law since it is with those provisions that there is most likely to be a potential overlap where the directors are in breach of their duty to take account of creditors' interests where the company is in financial distress.[176]

There are a number of relevant insolvency law provisions in both Scotland and England and Wales, some of which are common to both jurisdictions and others which apply only in one or the other. The relevant provisions in England and Wales have recently been considered in detail in this context by Keay,[177] who identifies the most important provisions in this context as the wrongful trading provision in section 214 of the Insolvency Act 1986, the provisions on preferences and transactions at an

[173] L Sealy 'Directors' Duties - An Unnecessary Gloss' [1988] CLJ 175 and 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law*.
[174] L Sealy 'Directors' Duties - An Unnecessary Gloss' [1988] CLJ 175 at 177. Similar sentiments were expressed in his 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law*.
[175] See, for example, C Riley, 'Directors' Duties and the Interests of Creditors' 1989 Co. Law 87; V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in A Clarke (ed) *Current Issues in Insolvency Law*; Feldman and Meisel (eds) *Corporate and Commercial Law: Modern Developments* Chapter 9 and especially, A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379 and 'Another Way of Skinning A Cat: Enforcing Directors' Duties For The Benefit Of Creditors' 2004 Insolv. Int. 1.
[176] For a good discussion of the main protections in company law, see E Ferran, 'Creditors' Interests and "Core" Company Law' 1999 Co. Law 314. Changes to a number of these provisions are in prospect following the Company Law Review discussed above, but the principle of creditor protection has generally been maintained.
[177] A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379. See also A Keay, 'Another Way of Skinning A Cat: Enforcing Directors' Duties For The Benefit Of Creditors' 2004 Insolv. Int. 1.

undervalue in sections 239 and 238 of the Insolvency Act 1986 respectively, the provision on transactions defrauding creditors in section 423 of the Insolvency Act 1986, the fraudulent trading provision in section 213 of the Insolvency Act 1986 and the misfeasance provision (as it is commonly known) in section 212 of the Insolvency Act 1986.[178] Of these, sections 212, 213 and 214 also apply in Scotland while sections 238, 239 and 423 do not. There are, however, broadly equivalent provisions to section 238 and 239 in Scotland in the form of the statutory provisions on gratuitous alienations and unfair preferences in sections 242 and 243 of the Insolvency Act 1986 respectively and there are also common law provisions for challenging gratuitous alienations and unfair preferences. There is no direct equivalent of section 423 of the Insolvency Act 1986 in Scotland.

Also relevant are the provisions of the Company Directors Disqualification Act 1986 which makes provision for the disqualification of directors and certain other persons. Unlike the other provisions referred to, however, this Act is not concerned with providing a remedy for creditors as such, although it does make provision for personal liability where a person has acted in breach of a disqualification. It does, however, enhance creditor protection by removing from the system directors whose conduct falls short of the appropriate standards and by discouraging such conduct in serving directors for fear of disqualification. Considerations of space preclude discussion of disqualification here, but it may be mentioned that trading while insolvent, where a director causes or permits a company to trade where he knows or ought to know that there is no reasonable prospect of creditors being paid, will generally result in disqualification for unfitness under section 6 of the Company Directors Disqualification Act 1986 on the basis that he has thereby breached his duties to the company even where such conduct would fall short of giving rise to liability for wrongful trading under section 214 of the Insolvency Act 1986.[179]

Turning back to the provisions of the Insolvency Act 1986, it seems appropriate to start with the wrongful trading provision in section 214 of the Insolvency Act 1986 since it is this section which has sometimes been said to preclude the need for any duty to creditors at common law[180] and it has already been referred to above. The section applies where a company has gone into insolvent liquidation and provides that where a director (or former director) knew or ought to have known at some time before the commencement of the liquidation that the company had no reasonable prospect of avoiding insolvent liquidation, he is liable to make such contribution (if any) to the company's assets as the court thinks proper. There is a defence where the director took every step which he ought to have taken with a view to minimising the loss to creditors. The director's conduct is assessed by a dual objective/subjective test which assumes that the director has the general knowledge, skill and experience that may reasonably expected of a person carrying out the director's functions and the

[178] See also V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditor' in A Clarke (ed) *Current Issues in Insolvency Law* which discusses the same provisions.

[179] For a detailed treatment of disqualification, see in particular A Walters and M Davis-White, *Directors' Disqualification & Bankruptcy Restrictions* (Sweet & Maxwell, London, 2005) and Mithani, *Directors' Disqualification* (Butterworths, London, 1998), a looseleaf publication which is regularly updated. A finding of liability for wrongful trading is a separate ground for disqualification under section 10 of the Company Directors' Disqualification Act 1986.

[180] L Sealy 'Directors' Duties - An Unnecessary Gloss' [1988] CLJ 175 and 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law*.

general knowledge, skill and experience that the director has. Although Sealy has said that the section covers the same ground as the duty to creditors,[181] in fact this is not the case. In particular, as was discussed by the Company Law Review Steering Group,[182] the common law duty arises at an earlier stage than the duty under section 214. In addition, section 214 is only available on insolvent liquidation, whereas a breach of duty, although perhaps most likely to be pursued on liquidation, can be pursued outside it, for example by an administrator or receiver. Furthermore, as the case law on section 214 has developed, a number of practical problems with bringing actions under the section have been identified.[183] It may be noted in passing that not all of these problems would necessarily arise in a Scottish context. Nonetheless, it is suggested that Keay's conclusions that section 214 has not lived up to its early promise and that there may be cases where a wrongful trading action would fall short but an action for breach of duty could succeed are justified.[184]

Similar points can be made in relation to the provisions on preferences and transactions at an undervalue in sections 239 and 238 of the Insolvency Act 1986 respectively. Section 239 applies on liquidation and administration, and provides that where a company has, at the relevant time, given a preference to any other person, the court shall make such order as it thinks fit for restoring the position to what it would have been if the preference had not been given. A preference is given where the company does anything which puts a creditor in a better position than he would have been on an insolvent liquidation and the company was influenced by a desire to put the creditor in that better position. The preference must have been given within the six months prior to liquidation or administration, unless it was given to a connected person in which case the time limit is 2 years, and the company must have been insolvent at the time of the preference or rendered insolvent as a result of it. Section 238 also applies on liquidation and administration, and provides that where a company has, at the relevant time, entered into a transaction at an undervalue, the court shall make such order as it thinks fit for restoring the position to what it would have been if the company had not entered into the transaction. There is a defence where the transaction was entered into in good faith for the purpose of carrying on the company's business and at the time it was entered into there were reasonable grounds for believing that the transaction would benefit the company. The transaction must have taken place within two years prior to liquidation or administration and again the company must have been insolvent at the time of the transaction or rendered insolvent as a result of it, although this is presumed in the case of a transaction with a connected person. Unlike section 214, sections 239 and 238 are available on administration as well as liquidation but, as already noted, a breach of duty can be pursued outside these processes. Furthermore, again a number of practical problems with bringing actions under these sections have been identified.[185] Again it may be noted in passing that not all of these problems would necessarily arise in a Scottish context, mainly because the equivalent provisions are different in a number of respects which are important in this

[181] L Sealy 'Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England)' in J Zeigel (ed) *Current Developments in International and Comparative Corporate Insolvency Law*.
[182] Referred to above.
[183] For a detailed description of the main problems, see A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379.
[184] *Ibid* at 393, 394.
[185] For a detailed description of the main problems, see A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379.

context.[186] Nonetheless, it is suggested that Keay's conclusion that a breach of duty action might be possible where an action under these provisions is not, for example where the person against whom the proceedings would fall to be brought is impecunious but the directors are not, is again justified.[187]

The provision on transactions defrauding creditors in section 423 of the Insolvency Act 1986 is much broader in scope than the other avoidance provisions in a number of respects: it is not confined to insolvency, there are no time limits and an action may be brought by any creditor. However, it relates only to transactions at an undervalue and it must be established that the person entering the transaction entered it for the purpose of putting assets beyond the reach of an actual or potential creditor or otherwise prejudicing such a person. Establishing this last requirement in particular has been identified as a problem with this provision which would not occur in the context of an action for breach of duty.[188]

The fraudulent trading provision in section 213 of the Insolvency Act 1986 applies only on liquidation and provides that where any of the company's business has been carried on with intent to defraud creditors of the company or of any other person or for any fraudulent purpose, any person who was knowingly a party to the fraudulent trading is liable to make such contribution (if any) to the company's assets as the court thinks proper. As with section 214, section 213 is only available on insolvent liquidation, whereas a breach of duty, although perhaps most likely to be pursued on liquidation, can be pursued outside it. Furthermore, as with the other sections considered, there are well-known difficulties with the section and a number of practical problems with bringing actions under it.[189] Again, it may be noted in passing that not all of the practical problems would necessarily arise in a Scottish context,[190] but once again it is suggested that Keay's conclusion that a liquidator would where possible seek to bring any action under a different provision is justified.[191]

The misfeasance provision in section 212 of the Insolvency Act 1986 applies on liquidation. Unlike the other provisions discussed here, it does not create any substantive rights but provides a procedural mechanism for enforcing an existing claim, including a claim for breach of duty. It is available where a director has misapplied or retained, or become accountable for, any money or other property of the company or has been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company. The successful action for breach of duty in *West Mercia Safety Wear Ltd v Dodd*[192] was brought under this section.

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[186] For example, one of the main problems with a preference action under section 239 of the Insolvency Act 1986 is the need to show that the company was influenced by a desire to prefer, but there is no need to establish such an intention to prefer in the context of an unfair preference action in Scotland.

[187] A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379 at 398, 400.

[188] *Ibid* at 401.

[189] For a detailed description of the main problems, see A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379.

[190] The difficulties with the wording of the section itself would, however, be equally applicable.

[191] A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379 at 402.

[192] (1988) BCLC 250.

Having reviewed these provisions, Keay concludes, rightly, that there are deficiencies and weaknesses in all of them[193] and that if there were no breach of duty claim, there would have been (and will be) cases where liquidators would not have succeeded and creditors would have been prejudiced.[194] He concludes further that while legislative provisions such as section 214 of the Insolvency Act 1986 mean that the ambit of the duty does not have to be as broad as was once thought, it is not irrelevant and has not been relegated to a "bit part";[195] in other words, the duty still has an important role to play. This presupposes, of course, that creditors are deserving of the (additional) protection which the duty brings. That, however, is a whole debate in itself which is beyond the scope of this paper. It may be noted, however, that Keay has argued, consistently with his views discussed above, that the limited protection which the duty brings can be so justified.[196]

Conclusion

Although the directors' duty to the creditors of a financially distressed company is now generally regarded as well established in principle in British law, there are still important aspects of it which remain more or less unclear. These include issues such as whether the duty is a direct or indirect duty, to which creditors the duty should be owed, the extent to which creditors' interests are to be taken into account, whether the test is subjective or objective, when the duty arises and whether the directors' knowledge of when the duty arises is to be tested subjectively or objectively.

The Company Law Review Steering Group in 2001 was split on the question of whether (a version of) the duty should be enacted in statute as part of a general statement of directors' duties, but produced a draft of such a provision for consideration which addressed many, if not all, of the present uncertainties surrounding the duty. However, the government has decided not to proceed with such a provision. Instead, the common law duty will be preserved and left to develop. Arguably this is unsatisfactory, since the uncertainties surrounding the duty will therefore remain and will have to be resolved by the courts if and when the opportunity permits. An important opportunity to clarify this area of the law has therefore been lost.

If the government rejected a statutory provision, was it right to retain nonetheless the common law? It has been seen that notwithstanding the existence of a number of other provisions aimed at protecting creditors' interests, there are gaps in these provisions which the duty may be able to fill. Arguably, therefore, it does have an important role to play in the modern law if the additional protection it can give creditors is seen to be justified.

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193 A Keay, 'The Duty of Directors To Take Account Of Creditors' Interests: Has It Any Role To Play?' [2002] JBL 379 at 405.
194 *Ibid* at 406.
195 *Ibid* at 409.
196 See A Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' 2003 66 MLR 665 and A Keay, 'A Theoretical Analysis Of The Directors' Duty To Consider Creditor Interests: The Progressive School's Approach' 2004 JCLS 304.