Directors' Duty to Creditors of a Financially Distressed Company: A Perspective from Across the Pond

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Directors’ Duty to Creditors of a Financially Distressed Company: A Perspective from Across the Pond

I. 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 British government to review core company law in 19982 and reported in 2001.3 Although the duty is now generally regarded as well-established in principle,4 there are important aspects of it that remain unclear, and the role of the duty in modern law has been questioned. This Article briefly outlines the development

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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.S. Sealy, Directors’ Duties—An Unnecessary Gloss, 47 C.L.J. 175 (1988) (Eng.) [hereinafter Sealy, Directors’ Duties—An Unnecessary Gloss]; see also L.S. Sealy, Personal Liability of Directors and Officers for Debts of Insolvent Corporations: A Jurisdictional Perspective (England), in Current Developments in International and Comparative Corporate Insolvency Law 485, 486–87 (Jacob S. Ziegel ed., 1994) [hereinafter Sealy, Personal Liability of Directors and Officers].
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of the duty in Great Britain before exploring 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.

II. THE DEVELOPMENT OF THE DUTY IN GREAT BRITAIN

As has been noted elsewhere, the development of the duty has been well documented, but a brief outline is useful here. 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:* "in discharging their duty to the company," the directors are required to take into account "the interests of its shareholders and its creditors. Any failure . . . to take [the creditors' interests into account] will have adverse consequences for the company" and for the creditors themselves. The approach in that case was followed in other Commonwealth cases that have also influenced the development of the law in Great Britain, most notably *Nicholson v. Permakraft (NZ) Ltd.* and *Kinsela v. Russell Kinsela Pty Ltd.*

In Great Britain, the first signs of recognition of the duty appeared in *Lonrho Ltd. v. Shell Petroleum Co. Ltd.*, 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." Other cases followed. In *Re Horsley & Weight Ltd.*, Buckley L.J. spoke of directors owing an indirect duty to creditors not to permit any unlawful reduction of capital. In

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5. See, e.g., *Keay, The Duty of Directors*, supra note 1, at 381.
8. Id. at 7.
11. [1980] 1 W.L.R. 627 (H.L.(E.)) (Eng.).
12. Id. at 634.
14. Id. at 1055–56.
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Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.,15 Dillon L.J. 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 Safetywear 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] [t]hey 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

The existence of the duty was also recognized 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 Welsfab 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,26 Re Pantone 485 Ltd.,27 Colin Gwyer & Associates Ltd. v. London Wharf (Limehouse) Ltd.,28 and Re MDA Investment Management Ltd.29

III. UNCERTAINTIES SURROUNDING THE DUTY

A. 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 be enforced only by the company.30

16. Id. at 585.
18. Id. at 252. The significance of the solvency or otherwise of the company to the existence of the duty is discussed further below.
21. [1987] 1 All E.R. 114 (H.L.) (Eng.).
22. [1987] 3 B.C.C. 535 (C.A.) (Eng.). 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] B.C.C. 600 (Ch.) (Eng.).
25. [1998] 1 B.C.L.C. 218 (Eng.).
26. 2002 S.L.T. 109 (Scot.).
27. [2002] 1 B.C.L.C. 266 (Ch.) (Eng.).
28. [2003] 2 B.C.L.C. 153 (Ch.) (Eng.).
29. [2005] B.C.C. 783 (Ch.) (Eng.). For a discussion of some of these more recent cases, see Keay, Directors Taking Into Account, supra note 1, at 303–05; see also Keay, Another Way of Skinning a Cat, supra note 1.
30. Or, in practice, the company’s liquidator, administrator or receiver.
The preponderance of authority favors the latter interpretation. In *Walker v. Wimborne*, the duty was expressed as one owed to the company, 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.*, 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 affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors." This can be interpreted as implying that there is a specific, separate duty to the creditors. 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)*, where Toulson J. said that a director "does not owe a direct fiduciary duty...[to] an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company."

It should be noted that neither approach is wholly free from difficulty. Potential problems that 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. These issues are discussed further below. Formulating the duty, however, as a direct one enforceable by individual creditors may be even more problematic, in spite of some apparent advantages. Although it has been said that 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 materialize. 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]." It has also been said

32. Id. at 7.
33. [1987] 1 All E.R. 114 (H.L.) (Eng.).
34. Id. at 118 (emphasis added).
35. See Finch, CORPORATE INSOLVENCY LAW, supra note 1, at 500.
37. Id. at 884.
38. Finch, CORPORATE INSOLVENCY LAW, supra note 1, at 501. See also Grantham, The Judicial Extension, supra note 6, at 4-13.
39. See Riley, Directors' Duties, supra note 6, at 276. The question of enforcement is discussed further below.
40. Id.

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that allowing a direct action by creditors would create the potential for double recovery.\textsuperscript{41} Mediating the duty through the company has the advantage of preserving an important principle of insolvency law, the \textit{pari passu} principle, by preventing any one creditor from stealing a march on other creditors and "preserv[ing] the procedural monopoly of liquidation proceedings for dealing with the claims of creditors against an insolvent company."\textsuperscript{42} It has further been said that if one accepts the neoclassical view of the company as dedicated to profit maximization, with the directors as agents of that profit maximization, a direct duty to creditors cuts across this, and a direct duty to creditors does not sit easily alongside the board's existing fiduciary duties.\textsuperscript{43} 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 tortious principles, has also been raised.\textsuperscript{44}

\textbf{B. Who Are the Creditors?}

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 \textit{Winkworth v. Edward Baron Development Co. Ltd.},\textsuperscript{45} Lord Templeman clearly included future creditors.\textsuperscript{46} In contrast, in \textit{Brady v. Brady},\textsuperscript{47} Nourse J. confined his formulation of the duty to existing creditors;\textsuperscript{48} and in \textit{Nicholson v. Permakraft (NZ) Ltd.},\textsuperscript{49} Cooke J. took the view that future creditors would normally take the company as it was and could look after their own interests.\textsuperscript{50} The latter approach has, however, been criticized on the basis that once the company has reached the stage where insolvent liquidation is inevita-

\textsuperscript{41} See Prentice, \textit{Creditor's Interests}, supra note 6, at 276; Prentice, \textit{Directors, Creditors, and Shareholders}, supra note 6, at 74.
\textsuperscript{42} See Prentice, \textit{Creditor's Interests}, supra note 6, at 276; Prentice, \textit{Directors, Creditors, and Shareholders}, supra note 6, at 75. Similar points are made in Finch, \textit{Insolvency and the Unsecured Creditor}, supra note 6, at 104. In relation to the last point, it should be noted that even if the duty is mediated through the company, it may fall to be enforced otherwise than on liquidation, for example, on administration or on the appointment of a receiver.
\textsuperscript{43} Grantham, \textit{The Judicial Extension}, supra note 6, at 12.
\textsuperscript{44} See, e.g., Finch, \textit{Corporate Insolvency Law}, supra note 1, 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 Alan Berg, \textit{The Company Law Review: Legislating Directors' Duties}, 2000 J. Bus. L. 472, 478–79 (U.K.).
\textsuperscript{45} [1987] 1 All E.R. 114 (H.L.) (Eng.).
\textsuperscript{46} \textit{Id}. at 118.
\textsuperscript{47} [1987] 3 B.C.C. 535 (C.A.) (Eng.). 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.
\textsuperscript{48} \textit{Id}. at 552.
\textsuperscript{50} \textit{Id}. at 250.
ble, there is little justification for differentiating between the two groups of creditors.\(^{51}\)

The issue is important because the interests of present and future creditors may conflict.\(^{52}\) So too may the interests of existing creditors: several commentators have noted 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.\(^{53}\) Some further guidance can now be found in the recent decision in *Re Pantone 485 Ltd.*,\(^{54}\) where Richard Field Q.C. stated that the "creditors" meant the "creditors as a whole, ie [the] general creditors[,] . . . [and] that if the directors act[ed] 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."\(^{55}\) 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?"\(^{56}\)

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.\(^{57}\) *Re Pantone 485 Ltd.*\(^{58}\) *may* lead to this result if "general creditors" can be regarded as unsecured creditors and "creditors with special rights in winding up"\(^{59}\) (whose interests must give way to the interests of the general creditors) can be regarded as including secured 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.\(^{60}\) As he himself acknowledges, however, such an approach has implications that may require further consideration. Whatever approach is taken, it is arguable that some distinc-

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52. 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 Finch, *Insolvency and the Unsecured Creditor*, supra note 6, at 103.

53. See, e.g., Riley, *Directors’ Duties*, supra note 6, at 90; Finch, *Insolvency and the Unsecured Creditor*, supra note 6, at 103; Finch, *Corporate Insolvency Law*, supra note 1, at 501–02.

54. [2002] 1 B.C.L.C. 266 (Ch.) (Eng.).

55. Id. at 286–87. In that case, the creditor in question was a preferential creditor. See also *Re MDA Inv. Mgmt. Ltd.*, [2005] B.C.C. 783 (Ch.) (Eng.), where Park J. also referred to the interests of the company’s creditors as a whole, although without elaborating on that concept.


58. [2002] 1 B.C.L.C. 266 (Ch.) (Eng.).

59. Id. at 286–87.

tion must be made in order to ensure that the duty is capable of operating effectively.\(^6^1\)

C. Are Creditors' Interests Entitled to Exclusive Consideration?

Case law is inconsistent 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 must 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, which 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, although others are clearer but point in contrary directions. In *Brady v. Brady*,\(^6^2\) 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."\(^6^3\) 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.*,\(^6^4\) referred to above, to the effect that where a company is insolvent, it is in a practical sense the creditors' assets that are being managed by the directors.\(^6^5\) It is suggested, however, 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 L.J. in *West Mercia Safetywear Ltd. v. Dodd*,\(^6^6\) 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,\(^6^7\) 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.\(^6^8\) In *Re Pantone 485 Ltd.*,\(^6^9\) Richard Field Q.C. 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,"\(^7^0\) again suggesting an exclusive focus on creditor interests. He

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\(^6^1\) See, e.g., *Finch, Corporate Insolvency Law, supra* note 1, at 502.
\(^6^2\) [1987] 3 B.C.C. 535 (C.A.) (Eng.). 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.
\(^6^3\) Id. at 532.
\(^6^4\) (1986) 4 N.S.W.L.R. 722 (Austl.).
\(^6^5\) *Compare Finch, Corporate Insolvency Law, supra* note 1, at 503, with Kinsela, 4 N.S.W.L.R. at 730.
\(^6^6\) [1988] B.C.L.C. 250 (C.A.) (Eng.).
\(^6^8\) See, e.g., Clydebank Football Club Ltd. v. Steedman, 2002 S.L.T. 109 (Scot.); see also *Re MDA Inv. Mgmt. Ltd.*, [2005] B.C.C. 783 (Ch.) (Eng.).
\(^6^9\) [2002] 1 B.C.L.C. 266 (Eng.).
\(^7^0\) Id. at 285.
cited as authority for this proposition Re Horsley & Weight Ltd., 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 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 that touch on the matter seem to favor an approach where creditors' interests are considered alongside other interests, particularly the interests of the shareholders. In Walker v. Wimborne, 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 (NZ) Ltd., 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 creditors were entitled to consideration in what is here described loosely as various circumstances related to insolvency. There is nothing to suggest, however, that creditors' interests should be considered exclusively in those circumstances. In Lonrho Ltd. v. Shell Petroleum Co. Ltd., 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 Re MDA Investment Management Ltd., 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., 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 that 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* and *Kinsela v. Russell Kinsela Pty Ltd.* as being concerned with the reorientation of focus from shareholder to creditor interests occurring around the point of insolvency rather than the issue of exclusivity of interests, and for the courts to stress that although creditor interests are 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 interests before insolvency. 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, but as noted above in relation to creditors with conflicting interests, there are problems with an approach that requires directors to consider conflicting interests.

**D. Is the Test Subjective or Objective?**

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

**E. When Does the Duty Arise?**

Another important area of uncertainty is identifying precisely when the duty arises. Some of the early cases, including *Walker v. Wimborne*, *Lonrho Ltd. v. Shell Petroleum Co. Ltd.*, and *Winkworth v. Edward Baron Development Co. Ltd.*, make no reference to a requirement for the company to be insolvent or in financial distress in order for the duty to arise. In another one of the early cases, *Re Horsley & Weight Ltd.*, however, Templeman L.J. 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 although 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 the judges use.

Thus, in *West Mercia Safetywear Ltd. v. Dodd*,97 as noted above, Dillon L.J. contrasted the position in the earlier case of *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.*98 where “the company . . . was amply solvent,” with the position in the instant case, where the company was insolvent.99 He then quoted with approval the dictum of Street J. in *Kinsela v. Russell Kinsela Pty Ltd.*100 to the effect that the duty arises when a company is insolvent.101 In *Brady v. Brady*,102 as noted above, Nourse J. said the interests of the company were in reality the interests of existing creditors alone where the company was “insolvent, or even doubtfully solvent.”103 In that case, the company in fact remained solvent after the transaction that was said to give rise to the breach of duty. Nourse J. went on to say, however, that “[t]he 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.104 This finding 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 (NZ) Ltd.*,105 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 course of action would jeopardise its solvency.”106 In *Facia Footwear Ltd. v. Hinchcliffe*,107 Sir Richard Scott V-C, having quoted the familiar passages from *Walker v. Wimborne*,108 *Nicholson v. Permakraft (NZ) Ltd.*,109 and *Kinsela v. Russell Kinsela Pty Ltd.*,110 the question of whether the duty would arise in circumstances short of insolvency was left open. *Kinsela*, 4 N.S.W.L.R. at 733. Of course, insolvency itself may have more than one meaning—this is discussed further below.

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96. *Id.* at 1056.
98. [1983] 2 All E.R. 563 (C.A.) (Eng.).
100. (1986) 4 N.S.W.L.R. 722 (Austl.).
101. *West Mercia Safetywear*, [1988] B.C.L.C. 250 at 253 (quoting *Kinsela*, 4 N.S.W.L.R. at 733). In *Kinsela v. Russell Kinsela Pty. Ltd.*, the question of whether the duty would arise in circumstances short of insolvency was left open. *Kinsela*, 4 N.S.W.L.R. at 733. Of course, insolvency itself may have more than one meaning—this is discussed further below.
102. [1987] 3 B.C.C. 535 (C.A.) (Eng.). 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.
103. *Id.* at 552.
104. *Id.*
106. *Id.* at 249.
107. [1998] 1 B.C.L.C. 218 (Eng.).
108. (1976) 137 C.L.R. 1 (Austl.).
sela v. Russell Kinsela Pty Ltd., went on to say that the duty arose in the instant case because the company and the whole group of which it was part were in “a very dangerous financial position.” In Colin Gwyer & Associates Ltd. v. London Wharf (Limehouse) Ltd., 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.” However, Park J. said the duty arose where the company, “whether technically insolvent or not, is in financial difficulties to the extent that its creditors are at risk.”

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 difficult, however, 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) and practical/liquidity insolvency (where the company is unable to pay its debts as they fall due).

None of the British cases, however, attempt to define what is meant by insolvency in this context, and the vagueness of the concept as a basis for directors’ duty has been criticized. 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, and it is unclear whether the directors’ knowledge of the insolvency is to be judged objectively or subjectively. Furthermore, it has been said that the point at which the company becomes insolvent is too late for the duty to creditors to arise.

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

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110. (1986) 4 N.S.W.L.R. 722 (Austl.).
112. [2003] 2 B.C.L.C. 153 (Ch.) (Eng.).
113. Id. at 154.
114. [2005] B.C.C 783 (Ch.) (Eng).
115. Id. at 805.
116. Both of these concepts are encompassed by the statutory test for insolvency in Insolvency Act, 1986, c. 6, § 123 (G.B.). Insolvency can be defined in other ways for other purposes: see, e.g., the test for wrongful trading in Insolvency Act, 1986, c. 45, § 214 (G.B.).
117. For more detailed discussion on this issue, see generally Grantham, The Judicial Extension, supra note 6; see also Andrew Keay, The Director’s Duty to Take into Account the Interests Of Company Creditors: When Is It Triggered?, 25 MELB. U. L. REV. 315, 322–29 (2001) [hereinafter Keay, The Director’s Duty to Take into Account].
118. See, e.g., Keay, The Director’s Duty to Take into Account, supra note 117, at 322–26; Finch, Directors’ Duties Towards Creditors, supra note 6, at 23–24; Finch, Corporate Insolvency Law, supra note 1, at 506.
119. See, e.g., Keay, The Director’s Duty to Take into Account, supra note 117, at 325; Finch, Corporate Insolvency Law, supra note 1, at 506–07. Finch suggests that the test must be an objective one if creditors’ interests are to be adequately protected. Id.
120. Keay, The Director’s Duty to Take into Account, supra note 117, at 326.
the most obvious indication that the residual risk is no longer borne by the shareholders. Thus the question posed by the court is not simply whether the company is insolvent, but that given the distribution of risk does it continue to be appropriate to regard the interests of shareholders as exclusively reflecting the corporate interest.121

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 otherwise122) is justified. Such an approach is consistent with the requirement in Nicholson v. Permakraft (NZ) Ltd.123 and Brady v. Brady124 that creditors’ interests be considered even where the company is solvent if a contemplated payment or other action would jeopardize that solvency, and is clearly reflected in dicta such as those in Colin Gwyer & Associates Ltd. v. London Wharf (Limehouse) Ltd.125 and Re MDA Investment Management Ltd.126 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 a company are such 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.”127 This test is objective, and he argues, would require a court 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.”128 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 fall due.129 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 objective and 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 that instead refers to the risk to (relevant) creditors’ interests would reflect the real

121. Grantham, The Judicial Extension, supra note 6, at 15.
122. See supra notes 117–21.
124. [1987] 3 B.C.C. 535 (C.A.) (Eng). 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.
125. [2003] 2 B.C.L.C. 153 (Eng.).
126. [2005] B.C.C 783 (Ch.) (Eng).
127. Keay, The Director’s Duty to Take into Account, supra note 117, at 334.
128. Id.
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focus of the duty more clearly, e.g., where the directors know or ought to have known that their conduct would put the (relevant) creditors' interests at risk.

IV. 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\textsuperscript{130} and reported in 2001.\textsuperscript{131} Directors' duties were 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,\textsuperscript{132} but it was intended that the Company Law Review would look at the

\begin{quote}

\textit{wider issue . . . [of] whether directors' duty to act in the interests of their company should be interpreted as meaning simply that they should act in the interests of the shareholders, or whether they should also take account of other interests, such as those of employees, creditors, customers, the environment, and the wider community.}\textsuperscript{133}
\end{quote}

The Company Law Review Steering Group published its first consultation document in February 1999.\textsuperscript{134} 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, "[c]ompanies are formed and managed for the benefit of shareholders, but subject to safeguards for the benefit of actual and potential creditors."\textsuperscript{135} The group 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. This normally means for the benefit of the shareholders as a whole."\textsuperscript{136} It said there is "an overriding obligation to ensure that creditors are not wrongfully exposed to insolvency, through general duties imposed by company law and insolvency law and special safeguards which apply to protect creditors in particular transactions (such as distributions of profits or capital)."\textsuperscript{137}

\begin{footnotes}
\item[130.] See Co. Law Investigations \& Directorate, supra note 2.
\item[131.] See Co. Law Rev. Steering Group, Final Report, supra note 3.
\item[132.] The Law Comm'n \& The Scottish Law Comm'n, Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, 1998 (Consultation Paper No. 153; Discussion Paper No 105).
\item[133.] Co. Law Investigations \& Directorate, supra note 2, at para. 3.7.
\item[135.] Id. at para. 5.1.4.
\item[136.] Id. at para. 5.1.5.
\item[137.] Co. Law Rev. Steering Group, The Strategic Framework, supra note 134, at para. 5.1.6 (citing West Mercia Safetywear, [1988] B.C.L.C. 250 (C.A.) (Eng.)).
\end{footnotes}
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The first consultation document considered two main approaches to the question of the proper scope of company law. The first approach, the “enlightened shareholder value” approach, regards the interests of the company as the interests of the shareholders, but also recognizes that promoting the interests of the shareholders will involve giving appropriate consideration to other interests. The second approach, the “pluralist” approach, seeks to redefine the interests of the company in such a way that that concept encompasses several different interests, not just the shareholders’ interests. The consultation document recognized that each of these approaches would require a different formulation of directors’ duties and sought views on various possible options. 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. They recommended, inter alia, a partial codification of the law on directors’ duties and produced a draft statutory statement of the main duties a director owes 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.

The Company Law Review Steering Group published a further consultation document in March 2000. This effectively adopted the enlightened shareholder value approach to company law, which had been what the majority of consultees had favored. So far as directors’ duties were concerned, the consultation document proposed, inter alia, to introduce “[a] statutory statement of principles, covering all the directors’ general duties,” which would include a requirement for “directors to achieve the success of the company for the benefit of shareholders by taking proper account of all relevant considerations for that purpose” and included a trial draft statutory statement. The first principle in the trial draft set out what it described

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138. Id. at para. 5.1.12.
139. Id. at para. 5.1.13.
140. Id. at para. 5.1.10.
142. THE LAW COMM’N & THE SCOTTISH LAW COMM’N, COMPANY DIRECTORS: REGULATING CONFLICTS OF INTERESTS AND FORMULATING A STATEMENT OF DUTIES (1999) (Consultation Paper No. 153; Discussion Paper No. 105), at para. 11.22–11.23. See also id. at para. 11.39, which deals with the issue of ratification where the company is or may become insolvent.
144. Id. at para. 2.11.
145. Id. at para. 2.19.
146. Id. 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.
as the directors’ duty of compliance and loyalty. It required a director to make honest and proper use of his powers in accordance with the company’s constitution and to exercise his powers in good faith, taking into account both the short- and the long-term consequences of his acts, to promote the success of the company for the benefits of all its members. It went on to state that the director should consider, 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 effect of its operations on the environment, and its need to maintain a reputation for high standards of business conduct.

The commentary on the trial draft said it was “intended to retain the current relationship between the general duties of directors and the rest of the law.” 147 “This 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.” 148 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.” 149 The commentary said that although “[a] number of British and Commonwealth court judgments have suggested that such a principle exists [giving as examples Nicholson v. Permakraft (NZ) Ltd. 150 and West Mercia Safetywear Ltd. v. Dodd], . . . in reality the cases seem capable of resolution on the basis of other principles and have been strongly criticised on these grounds.” 152 It was also said that “[c]reditors should have a remedy in a winding up or on the basis of their contracts and . . . that the prospect of personal liability to them on the part of directors has a salutary deterrent effect when the company is threatened with insolvency.” 153 Furthermore, “[c]reditors’ interests are already properly included within the inclusive loyalty principle,” the commentary said, and enactment of an additional principle would “cut across section 214 of the Insolvency Act 1986” 154 which “enables a liquidator . . . in an insolvent winding up to recover a contribution from a director who failed to take necessary action to protect creditors where insolvency was inevitable, . . . a separate and detailed overriding provision which” there was no reason to change. 155 The inclusion of the additional principle in the statement was therefore rejected. 156 It was thought, however, that the position with respect to ratification might be
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different, 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." 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." What "special principles" were meant was not specified, and it was therefore unclear 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 also unclear whether that duty was intended to survive, notwithstanding the decision to exclude it from the statement of duties.

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

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 Review Steering Group was published in 2001, however, the revised statement of directors' duties included provisions on "the duties of directors to have regard to the interests of creditors where there is a risk of insolvency . . ." The reasons for this were explained in some detail. It was said that it was important to advise directors that they might need to consider different factors "where the company is insolvent or threatened by insolvency [and that failing] to do so would risk misleading directors by omitting an important part

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157. Id.
158. Id. at para. 3.81.
159. Id. at para. 3.73.
161. Id. at para. 3.12.
162. Co. LAW REV. STEERING GROUP, FINAL REPORT, supra note 3.
163. Id. at para. 3.11.
164. Id.
of the overall picture. Also noted was the belief that the earlier technical problems and concerns about including the duty could be resolved.

The key issue for the Company Law Review Steering Group was when "the normal rule, that a company is to be run in the interests of its . . . shareholders, [should] be modified by an [additional] obligation to . . . regard . . . the interests of creditors, or, in an extreme case, . . . to override the interests of [shareholders] entirely . . ." The group noted the "risk that insolvency may occur unexpectedly . . . [b]ut as insolvency becomes more imminent, the normal synergy between the interests of members, . . . and of creditors, . . . progressively disappears. As the margin of assets reduces, so [does] the incentive on directors to avoid risky strategies which endanger the assets . . ." It noted that the present law provided two solutions to this problem. The first was section 214 of the Insolvency Act 1986, in terms of which the directors are “liable to contribute towards the funds available to creditors in an insolvent winding up, where they ought to have recognised that the company had no reasonable prospect of avoiding insolvent liquidation and then failed to take all reasonable steps to minimise the loss to creditors." It was proposed that this rule be included in the statement of directors’ duties in order “to make clear the point at which the normal duty of loyalty . . . is displaced," 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” recognized in case law. The Company Law Review Steering Group suggested that this principle

would require directors, where they know or ought to recognise that there is a substantial probability of an insolvent liquidation, to take such steps as they believe, in their good faith judgement, appropriate to reduce the risk, without undue caution and thus continuing also to have in mind the interests of members.

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165. Id. at para. 3.12.
166. Id. at paras. 3.12, 3.13.
168. Id. at para. 3.15.
169. Id. at para. 3.16 (emphasis in original). It should be noted that section 214 in fact requires the directors to have taken “every step” to minimize the loss to creditors, which is a somewhat different thing. Insolvency Act, 1986, c. 45, § 214 (G.B.).
170. Co. LAW REV. STEERING GROUP, FINAL REPORT, supra note 3, at para. 3.16.
171. Id. at Annex C, Sched. 2, para. 8, at 347.
172. Id. at para. 3.17.
173. Id.
It added that

"[t]he 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 is no reasonable prospect of avoiding insolvent liquidation the interests of creditors become overriding under the first (section 214) test."\(^{174}\)

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,"\(^{175}\) and it considered what it saw as the arguments for and against such a rule. In favor of the rule was the argument that "[w]ithout it, directors would apparently, . . . be bound to act in the ultimate interests of members until all reasonable prospect of avoiding shipwreck had been lost. [W]here insolvency is less than inevitable but the risk is substantial, directors should, . . . consider the interests of members and creditors together."\(^{176}\) Against it was the argument that it might have a "'chilling' effect [and] . . . the risk that directors may run down or abandon a going concern at the first hint of insolvency."\(^{177}\) It was recognized that the balanced judgment the rule would require was "'a difficult and indeterminate one [and that] [f]ears of personal liability may lead to excessive caution."\(^{178}\) It was said that the fact that "case law already imposes such a duty is not a sufficient reason for retaining it unless . . . it will not in practice lead to failure of viable businesses."\(^{179}\) It was thought, however, that the concerns could at least to some extent be met by careful drafting, by requiring the judgment to be subject to a subjective rather than an objective test and "by providing that the duty only arises 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."\(^{180}\) It was also noted that "where the business is threatened with insolvency there are procedures short of full liquidation open to directors which both provide protection for creditors and preserve" the business.\(^{181}\) The Company Law Review Steering Group was, however, split on whether (a version of) the common-law rule should be included in the statement of directors' duties.\(^{182}\) Those against

\(^{174}\) Id.
\(^{175}\) Id. at para. 3.18.
\(^{176}\) Id.
\(^{177}\) Id. at para 3.19.
\(^{178}\) Id.
\(^{179}\) Id. at para. 3.20.
\(^{180}\) Id.
\(^{182}\) Co. LAW REV. STEERING GROUP, FINAL REPORT, supra note 3, at para. 3.20.
the inclusion of the rule thought that 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.” 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 take place.

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 account in good faith of all the material factors that it is practicable in the circumstances for him to identify.

(3) The Notes to paragraph 2 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 success of the company 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.
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 views on whether the ways in which it did were appropriate might well differ. 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 be unable to pay its debts, a concept that is defined in the Insolvency Act 1986 and includes both balance sheet and practical/liquidity insolvency. It thus addressed the uncertainty as to the point at which the duty arises in the present law, although the practical problems in determining when that point has been reached will remain, as concerned those arguing against the duty. It provided that the test for identifying whether the relevant point has been reached is objective although 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. Thus, it 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.

V. THE GOVERNMENT’S RESPONSE

The government accepted the Company Law Review Steering Group’s recommendation to introduce a statutory statement of principles covering all directors’ general duties, but 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.

188. Id. at Annex C, Sched. 2, paras. 1, 2, at 345; Id. at Explanatory Notes, paras. 11-19, at 351-52; Co. Law Rev. Steering Group, Developing the Framework, supra note 143, at Annex B, paras. 1-10, at 408-10.


190. Id. at Annex C, Explanatory Notes, para. 26, at 354. The explanatory notes which accompany the statement of directors’ duties make it clear that it is this definition which is to apply.


192. Secretary of State for Trade & Industry, Modernising Company Law, Cm. 5553 (July 2002), at paras. 3.2-3.7.
The white paper *Modernising Company Law*, issued in July 2002,\(^{193}\) said that the government had carefully considered both suggestions but concluded that the weight of argument was against including any duties relating "to creditors in the statutory statement."\(^{194}\) In relation to the proposed provision based on section 214 of the Insolvency Act 1986, it was said that it would do the following: (i) "de-couple the obligations imposed [under the section] from the remedies [available under it],"\(^{195}\) (ii) "unhelpfully conflate company and insolvency law,"\(^{196}\) and (iii) would be 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.\(^{197}\) It is suggested that the government's reasoning on this point is sound and that there is no need to repeat a specific duty arising under insolvency law in a general statement of directors' duties.\(^{198}\)

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 . . . ."\(^{199}\) As has been pointed out elsewhere, the government's reasoning here is perhaps less sound.\(^{200}\) First, Keay argues that directors might equally well be cautious out of fear of being held liable for wrongful trading under section 214 of the Insolvency Act 1986,\(^{201}\) although, of course, under that provision the duty arises only at a later stage.\(^{202}\) It might be added that directors might equally well be cautious out of fear of disqualification.\(^{203}\) Second, because it is widely accepted that the earlier a rescue process is commenced the better the chances it will succeed, if the duty to consider creditors at an earlier stage caused the directors, as it arguably could, 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.\(^{204}\)

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193. Id.
194. Id. at para. 3.10.
195. Id. at para. 3.12.
196. Id. at para. 3.13.
197. Id. at paras. 3.12, 3.13. It was considered that the comprehensive guidance for directors that the government was proposing be prepared would enable directors' attention to be drawn to their additional duties under the insolvency legislation. Id.
198. Id. at para. 3.13.
199. Id. at para. 3.11.
201. Id.
202. *See* Insolvency Act, 1986, c. 45, § 214(1) (G.B.) (when the director knew or ought to have known that the company could not reasonably avoid insolvent liquidation.).
203. Disqualification is discussed *infra*.
204. *See also* Keay, *Directors Taking into Account*, supra note 1, at 306.
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The white paper offered 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," as 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. It was recognized, however, that this would not achieve the effect the draft provision was intended to achieve, and it was not taken forward.

The explanatory notes accompanying the statement of directors’ duties in the Company Law Review 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. The second option 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 did not specifically address what should be done about the existing common law. The draft Company Law Reform Bill that was to implement the proposed changes to company law published in July 2005, however, effectively provided for the common law to survive: the provision setting out the director’s (further refined) duty to promote the success of the company for the benefit of its members provided that the duty was “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.” The explanatory material accompanying the draft stated that this 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 the creditors.

The Company Law Reform Bill introduced into Parliament on November 1, 2005 followed the terms of the draft in this respect. The Guidance on Key Clauses issued with the Bill made it clear that “[t]he statutory duties [embodied in the bill]...
do not cover all the duties that a director may owe to the company." It further stated that other duties are imposed elsewhere in legislation or remain uncodified, specifically referring in the latter context to "any duty to consider the interests of creditors in times of threatened insolvency." It also specifically stated that the inclusion of the provision to the effect that the director's duty to promote the success of the company for the benefit of its members 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 would leave the common law to develop in this area. That provision has now been enacted in the form of section 172(3) of the Companies Act 2006. This approach may permit more flexibility in developing the duty than a statutory provision would have provided. It is suggested, however, that since the duty has been retained, a specific provision in the legislation—providing that it was carefully thought through and drafted—would have been more satisfactory because it could have resolved at least some of the present uncertainties surrounding the duty. These uncertainties will now have to await clarification by the courts as and when the opportunity arises. The provision will, however, at least put directors on notice that they have the duty, even if they cannot determine its content with certainty.

VI. THE ROLE OF THE DUTY IN MODERN BRITISH LAW

The directors' duty to creditors thus remains 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. The law already gives the courts ample scope to deal with all potential abuses of trust by company directors, he has said, and even if that had not been so before 1986, the (then) new wrongful-trading provision in section 214 of the Insolvency Act 1986 would allow for developments on a statutory footing that were properly integrated with insolvency law as a whole. Other commentators, however, have pointed out that this may be incorrect and that the duty does

214. Id. at § 305.
215. Id. at §§ 329–30.
217. See Sealy, Directors' Duties—An Unnecessary Gloss, supra note 4, at 175–77; Sealy, Personal Liability of Directors and Officers, supra note 4, at 488.
218. Sealy, Directors' Duties—An Unnecessary Gloss, supra note 4, at 177; Sealy, Personal Liability of Directors and Officers, supra note 4, at 494, 496.
have a role to play in supplementing other provisions for the protection of creditors' interests.\(^{219}\)

A variety of provisions to protect creditors' interests are built into both company and insolvency law. This Article concentrates on the main protections in insolvency law, because it is with those provisions that an overlap is most likely to occur where the directors of a financially distressed company are in breach of their duty to take account of creditors' interests.\(^{220}\)

England, Wales, and Scotland all have relevant insolvency-law provisions, some of which are common to both jurisdictions and others of which apply only in one or another. The relevant provisions in England and Wales have recently been considered in detail in this context by Keay,\(^{221}\) who identifies the most important provisions as the wrongful-trading provision in section 214 of the Insolvency Act 1986; the provisions on preferences and transactions at an 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.\(^{222}\) Of these, sections 212, 213, and 214 also apply in Scotland,\(^{223}\) although sections 238, 239, and 423 do not.\(^{224}\) There are, however, broadly equivalent provisions to sections 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,\(^{225}\) 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.

It seems appropriate to start with the wrongful-trading provision in section 214 of the Insolvency Act 1986 because this section has sometimes been said to preclude the need for any duty to creditors at common law\(^{226}\) and has already been referred to above. The section applies where a company has gone into insolvent

\(^{219}\) See, e.g., Riley, Directors' Duties, supra note 6, at 90; Finch, Insolvency and the Unsecured Creditor, supra note 6, at 94, 97, 111; Corporate and Commercial Law, supra note 6, at ch. 9; Keay, The Duty of Directors, supra note 1, at 380; Keay, Another Way of Skinning a Cat, supra note 1, at 7.

\(^{220}\) For a good discussion of the main protections in company law, see generally Ellis Ferran, Creditors' Interests and 'Core' Company Law, 20 Co. L.J. 314 (1999) (U.K.). Changes to several of these provisions will be made by the Companies Act 1986, c. 46 (G.B.), but the principle of creditor protection has generally been maintained.

\(^{221}\) Keay, The Duty of Directors, supra note 1, at 380; Keay, Another Way of Skinning a Cat, supra note 1, at 3–8.

\(^{222}\) See also Finch, Insolvency and the Unsecured Creditor, supra note 6 (discussing various provisions of the Insolvency Act 1986).


\(^{224}\) Id. at §§ 238–39, 423.


\(^{226}\) Sealy, Directors' Duties—An Unnecessary Gloss, supra note 4, at 177; Sealy, Personal Liability of Directors and Officers, supra note 4, at 494, 496.
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 defense where the director "took every step [he ought to have taken] with a view to mini[z]ing the potential loss to the company's creditors."

The director's conduct is assessed by a dual objective/subjective test that assumes that the director has the general knowledge, skill, and experience that may reasonably be expected of a person carrying out the director's functions and the 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, this is not in fact the case. In particular, as the Company Law Review Steering Group discussed, the common-law duty arises at an earlier stage than the duty under section 214. In addition, section 214 is available only 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, practical problems with bringing actions under the section have been identified, although it may be noted in passing that not all of these problems, some of which have now been resolved, would necessarily have arisen in a Scottish context. Nonetheless, it is suggested that Keay is justified in concluding that section 214 has not lived up to its early promise and that a wrongful-trading action may sometimes fall short, but an action for breach of duty could succeed.

Similar points can be made in relation to the provisions on preferences and transactions at undervalue in sections 239 and 238, respectively, of the Insolvency Act 1986. Section 239 applies on liquidation and administration, and provides that "[w]here [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 that puts a creditor in a

228. Id. at § 214(3).
229. Id. at § 214(4).
230. Sealy, Personal Liability of Directors and Officers, supra note 4, at 488.
231. See supra notes 167–190 and accompanying text.
234. For a detailed description of the main problems, see id. at 389–91.
235. In particular, it was a problem in England and Wales that the costs of bringing an action did not count as expenses of the liquidation. This problem has now been solved by amending the provisions of r 4.218 of the Insolvency Rules 1986, SI 1986/1925 but never arose in Scotland because the Scottish rules were worded differently. See Insolvency (Scotland) Rules 1986, SI 1986/1915, r 4.67.
better position than he would have been in 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 before liquidation or administration, unless it was given to a connected person. In this case, the time limit is two years, and the company must have been insolvent at the time of the preference or been rendered insolvent as a result of it. Section 238 also applies on liquidation and administration and provides that "[w]here the company has at a 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 that transaction." There is a defense where the transaction was entered into "in good faith and for the purpose of carrying on [the company's] business, and that 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 before 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. Again, a number of practical problems with bringing actions under these sections have been identified. It may be noted again 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 important respects. Nonetheless, it is suggested that Keay is justified in concluding that a breach-of-duty action might be possible where the person against whom the proceedings would be brought is impecunious but the directors are not.

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. It relates, however, only to transac-

238. Id. at § 239(4)(b).
239. Id. at § 240(1)(b).
240. Id. at § 240(1)(a).
241. Id. at § 238(1)–(3).
242. Id. at § 238(5).
243. Id. at § 240(1)(a)–(b).
244. Id. at § 238(1), § 239(1).
246. See id. at 397–99.
247. 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. Compare Insolvency Act, 1986, c. 45, § 239(5) (Eng. & Wales) with Insolvency Act, 1986, c. 45, § 243 (Scot.).
249. See Insolvency Act, at § 423.
tions 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 that would not occur in the context of an action for breach of duty.

The fraudulent-trading provision in section 213 of the Insolvency Act 1986 applies only on liquidation. It provides that where any of the company’s business “has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, ... any persons who were knowingly parties [to the fraudulent trading] are to be liable to make such contributions (if any) to the company’s assets as the court thinks proper.” As with section 214, section 213 is available only 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. Again, it may be noted in passing that not all of the practical problems would necessarily arise in a Scottish context, but once again it is suggested that Keay is justified in concluding that a liquidator would, where possible, seek to bring any action under a different provision.

The misfeasance provision in section 212 of the Insolvency Act 1986 applies on liquidation. Unlike the other provisions discussed, 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 been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.” An application under the section may be made by the liquidator, a creditor or a contributory, but in all cases any property or monies recovered will form part of the company’s assets available for distribution to all creditors. The successful action for breach of duty in West Mercia Safetywear Ltd. v. Dodd was brought under this section.
Having reviewed these provisions, Keay concludes, rightly, that there are deficiencies and weaknesses in all of them and that absent a breach-of-duty claim, there have been and will continue to be cases where liquidators would have failed and "creditors would have been prejudiced." He concludes further that although 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, the duty is not irrelevant and has not been relegated to the role of a 'bit part.' In other words, the duty still has an important role to play. This conclusion presupposes, of course, that creditors deserve the additional protection the duty brings. That question is a whole debate in itself and lies beyond the scope of this Article. Still, it may be noted that Keay has argued, consistently with his views discussed above, that the limited protection the duty brings can be so justified.

Also relevant in this context are the provisions of the Company Directors Disqualification Act 1986, which provides for the disqualification of directors and certain other persons on a variety of grounds. Unlike the other provisions discussed above, 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 a detailed discussion of disqualification here, but it may be noted that under section 6 of the Company Directors Disqualification Act 1986, the court has a duty to disqualify a director or former director of a company that has at any time become insolvent where his conduct as a director of that company, either alone or together with his conduct as a director of any other company or companies, makes him unfit to be concerned in the management of a company. In determining whether a person’s conduct makes him unfit to be concerned in the management of a company, the court is directed to have regard, in particular, for the matters mentioned in Part I of Schedule 1 to the Act and, where the company has become insolvent, to the matters mentioned in Part II of

266. Id. at 406.
267. Id. at 409.
268. See Keay, Contractarian Concerns, supra note 1, at 680–87; Keay, A Theoretical Analysis, supra note 1, at 342–44.
270. Id. at §§ 13–15.
271. Id. § 6(2). A company becomes insolvent for this purpose where it "goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up, [when] the company enters administration, or [when] an administrative receiver of the company is appointed." Id. In each such case, the relevant insolvency practitioner has a duty to report on the conduct of the directors/former directors of the company to the Secretary of State, who will then decide whether it is expedient in the public interest to make an application for disqualification under section 6. Id. at § 7(3)–(4).
272. Id. at sched. 1, part I.
Schedule 1, as well. The matters mentioned in Part I of Schedule 1 include “[a]ny misfeasance or breach of any fiduciary or other duty by the director in relation to the company.” The courts have held that 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, can amount to unfitness justifying disqualification under section 6 of the Company Directors Disqualification Act 1986. Courts have reasoned that the director 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. The duty therefore has an important role to play in this context as well, and has perhaps been better developed by the courts here than in the context of specific actions for breach of the duty.

VII. 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, important aspects of it still remain more or less unclear. These include whether the duty is a direct or an indirect one, which creditors should be owed the duty, the extent to which creditors’ interests are to be taken into account, whether the test is subjective or objective, when would the duty arise, 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. It did, however, produce for consideration a draft of such a provision that addressed many, if not all, of the present uncertainties surrounding the duty. The government decided not to proceed with such a provision, and the common-law duty has instead been preserved and left to develop. This decision is arguably unsatisfactory, because 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 nonetheless to retain the common law? It has been seen that despite other provisions aimed at pro-

273. Id. at sched. 1, part II.
274. Id. at sched. 1, para. 1.
276. See generally A. Walters and M. Davis-White, Directors’ Disqualification & Bankruptcy Restrictions (Sweet & Maxwell London 2005); Mithani, Directors’ Disqualification (Butterworth’s 1998). A finding of liability for wrongful trading is a separate ground for disqualification. See, e.g., Company Directors’ Disqualification Act, 1986, c. 46, § 10(1).
278. Id. at annex C, sched. 2, § 8, at 347.
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tecting creditors’ interests, gaps remain that the duty might be able to fill. In addition, it has a role to play in the context of disqualification. Arguably, therefore, it does still have an important role to play in the modern law if the additional protection it can give creditors is seen to be justified.