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# FINANCIALLY DISTRESSED COMPANIES, PREFERENTIAL PAYMENTS AND THE DIRECTOR'S DUTY TO TAKE ACCOUNT OF CREDITORS' INTERESTS

Andrew Keay\*

## I Introduction

It is trite law that when a company is insolvent, near to insolvency or in dire financial straits the company's directors are obliged to take into account the interests of the company's creditors,<sup>1</sup> and the interests to be taken into account are those of the creditors as a whole.<sup>2</sup> This rule of law has been developed by the courts over the past 40 years and when the Companies Act 2006 ("the Act") was enacted it included a provision, s.172(3), that effectively codified the rule of law.<sup>3</sup> Section 172(3) provides that: "the duty imposed by this section [s.172(1)] has effect 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." Proceedings against directors that are brought for a breach of s.172(3) are usually initiated by an administrator or a liquidator. These office-holders may commence proceedings against directors if the latter have failed, in their actions and decisions, to take into account the interests of creditors before the company entered administration or liquidation. Proceedings have historically been brought primarily by liquidators<sup>4</sup> so for that reason and for ease of exposition the balance of this paper will refer to claims brought by liquidators.

Proceedings under s.172(3) might be based on a variety of actions of the directors engaged in before the advent of liquidation. One kind of claim that liquidators may wish to make is that when subject to the duty under s.172(3) the directors authorised a payment to a creditor of the company and payment was not in the interests of creditors as a whole as it preferred the recipient creditor over the general body of creditors. That is, the recipient got more than the other creditors as the latter have to rely on receiving a payment out of the liquidation, and that will be less than that which the recipient received before liquidation. In a liquidation all unsecured creditors, save for those who are granted certain priority to payment under the Insolvency Act 1986, share in the funds of the company in liquidation on a *pari passu* basis, that is, equally and rateably. Besides having a possible claim under s.172(3), where a payment of the kind just referred to has been given, a liquidator will have a claim against the creditor if it fulfils the conditions for a preference under s.239 of the

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<sup>1</sup> If authority is needed, see, for instance, *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 B.C.C. 30; *Bilta (UK) Ltd (in liquidation) and others v Nazir and others (No 2)* [2015] UKSC 23; [2016] A.C. 1; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337. But see the comment of David Richards L.J. in *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 at [195].

<sup>2</sup> *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266; *Ghlm Trading Ltd v Maroo* [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [168]; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [106]; *Capital For Enterprise Fund A LP and another v Bibby Financial Services Ltd* [2015] EWHC 2593 (Ch) at [89]; *Westpac Banking Corporation v Bell Group Ltd (in liq)* (No 9) [2009] WASCA 223 at [1092].

<sup>3</sup> Cases indicate that the provision preserves the common law: *Caley Oils Ltd v Wood* [2018] CSOH 42 at [43].

<sup>4</sup> For actions brought by administrators, see *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 B.C.L.C. 218; *Re Agrave Ltd* (unreported, 25 June 2012, Mr N. Strauss QC, Ch. D).

Insolvency Act 1986 in England and Wales or under s.243 in Scotland. If a payment constitutes a preference under either s.239 or s.243 the recipient of it will be ordered to repay the sum to the liquidator for the benefit of all of the company's creditors.

Some comments in the case law<sup>5</sup> and in academic literature<sup>6</sup> have questioned whether a liquidator should be entitled to succeed against a director under s.172(3) where the respondent director made a payment, on behalf of his or her company, to a creditor of the company, and this is even where it gives the creditor a preference over the other creditors of the company.<sup>7</sup> This paper explores that issue. It is an issue that has not been examined in great depth thus far and it is of practical importance because the answer to the issue raised above could potentially restrict liquidators quite severely in their attempts to swell the pool of funds that can be distributed to the general body of creditors. The contribution of the paper is to resolve some apparent inconsistencies in the case law and to clarify what is the soundest view in relation to permitting s.172(3)'s employment in challenging preference-like payments.

The paper develops as follows. First, it very briefly explains the duty that exists under s.172(3).<sup>8</sup> Secondly, there is an explanation, again brief, of the nature of a preference and what conditions must be satisfied under the Insolvency Act 1986 if a liquidator is to claim successfully against a creditor who has been paid before liquidation. Next there is an analysis of the various issues that relate to whether the giving of a preference payment can be challenged under s.172(3). Consideration is given both to where a payment is a preference within the Insolvency Act 1986 and where it is not. The final substantial section of the paper examines the specific concern that has been emitted that a claim under s.172(3) cannot be brought where there has been a preference-like payment as in such a situation the company does not sustain any loss. The paper ends with some concluding remarks.

## II The Duty to Account for Creditors' Interests

Section 172(3) refers to a rule of law that requires directors, in certain circumstances, to consider or act in the interests of creditors of the company rather than to fulfil the duty set out in s.172(1) which is to promote the success of the company for the benefit of the members of the company. Section 172(3) refers to the common law that developed in the UK during the 20 years preceding the enactment of s.172(3) and has continued to do so. The

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<sup>5</sup> For example, *Singer v Beckett; Re Continental Assurance Co of London Plc (in liquidation)* [2007] 2 B.C.L.C. 287; *GHLM Trading Ltd v Maroo* [2012] EWHC 61; [2012] 2 B.C.L.C. 369; *Moulin Global Eyecare Holdings Ltd v Lee* [2012] HKCFI 989; [2012] 4 HKLRD 263 and on appeal, [2012] HKCA 537.

<sup>6</sup> See, K. van Zwieten, "Director Liability in Insolvency and Its Vicinity" (2018) 38 O.J.L.S. 382.

<sup>7</sup> Arguably, in *Northampton Borough Council v Cardoza* [2017] EWHC 504 (Ch) at [27]–[32] Newey J. engaged in an attempt to reconcile the case law.

<sup>8</sup> The duty has been discussed on many occasions. For instance, see, D. D. Prentice, "Creditor's Interests and Director's Duties" (1990) 10 O.J.L.S. 265; R. Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] J.B.L. 1; D. Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323; J. Ziegel, "Creditors as Corporate Stakeholders : The Quiet Revolution – An Anglo-Canadian Perspective" (1993) 43 *University of Toronto Law Journal* 511; A. Keay, *Company Directors' Responsibilities to Creditors* (Abingdon, Routledge-Cavendish, 2007); A. Keay, "Directors' Duties and Creditors' Interests" (2014) 130 L.Q.R. 443; K. van Zwieten, "Director Liability in Insolvency and Its Vicinity" (2018) 38 O.J.L.S. 382.

seminal case is in fact the Australian decision in *Walker v Wimborne*,<sup>9</sup> and particularly a dictum of Mason J. where his Honour said that when their company is in severe financial difficulty directors had to take account of the interests of the creditors of the company. This principle was applied in a number of cases in Commonwealth jurisdictions during the 1980s,<sup>10</sup> and was the basis of the decision of the English Court of Appeal case, *Liquidator of West Mercia v Dodd*<sup>11</sup> (“*West Mercia*”), the first UK court to deal with the matter where it was a central part of the claimant’s case. As mentioned earlier, the principle is now virtually codified via s.172(3). Since the enactment of the Act there has been a significant number of cases where s.172(3) has been relied on by liquidators in bringing legal action against directors of companies that had ended up in insolvent liquidation.<sup>12</sup>

The obligation arises when the company is insolvent, near to insolvent or in financial difficulties, but not, according to the Court of Appeal in the recent case of *BTI 2014 LLC v Sequana SA*,<sup>13</sup> where there is a real risk of insolvency. If the obligation does arise then the directors must take into account the interests of the creditors in making decisions in relation to the affairs of the company. The test as to whether directors are liable or not under s.172(3) is subjective. That is, directors are not liable if they act in good faith and actually consider the interests of the creditors when making decisions while subject to the s.172(3) obligation.<sup>14</sup> If directors fail to consider creditor interests then in order to ascertain whether they are liable the court is to ask whether an intelligent and honest person in the position of the directors, could, in the whole of the circumstances, have reasonably believed that the action that is impugned was for the benefit of the creditors.<sup>15</sup>

It should be noted that in practice liquidators will usually bring a claim that there has been a breach of the duty in s.172(3) by way of a misfeasance application under s.212 of the Insolvency Act 1986<sup>16</sup> as it provides for a speedier hearing. Section 212 provides, inter alia, that a court may, on the application of a liquidator examine into the conduct of an officer of the company where, inter alia, there has been a breach of fiduciary or other duty.

### III Preferences and the Insolvency Act 1986

The paper is focused on whether s.172(3) of the Act is able to be employed by a liquidator against a director to recover the amount paid out to a creditor when the director was

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<sup>9</sup> (1976) 137 C.L.R. 1.

<sup>10</sup> For example, see *Grove v Flavel* (1986) 4 A.C.L.C. 654; *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 A.C.L.R. 395; *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453; *Jeffrey v NCSC* (1989) 7 A.C.L.C. 556.

<sup>11</sup> (1988) 4 B.C.C. 30.

<sup>12</sup> For instance, see *Roberts v Frohlich* [2011] EWHC 257 (Ch); [2012] B.C.C. 407; *GHLM Trading Ltd v Maroo* [2012] EWHC 61; [2012] 2 B.C.L.C. 369; *Re HLC Environmental Projects Ltd (in liq)* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337; *BTI 2014 LLC v Sequana SA* [2016] EWHC 1686 (Ch); *Ball v Hughes* [2017] EWHC 3228 (Ch); *Joint Liquidators of CS Properties (Sales) Ltd* [2018] CSOH 24. The rule of law has continued to have been relied on in many parts of the Commonwealth as well as in Ireland.

<sup>13</sup> [2019] EWCA Civ 112.

<sup>14</sup> *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885 at [87] and applying *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch. 62.

<sup>15</sup> *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885 at [87] and applying *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch. 62.

<sup>16</sup> For example, *Caley Oils Ltd v Wood* [2018] CSOH 42 (a Scottish case so the claim was under s.243 of the Insolvency Act 1986).

subject to the duty to consider creditors' interests. However, as indicated earlier, such a payment might constitute a preference and a liquidator could challenge it under the Insolvency Act 1986, and it is necessary as a basis for later discussion for us to identify what a preference is in terms of this Act. The conditions that have to be established if a liquidator is to challenge successfully a payment to a creditor before liquidation, on the basis that it is a preference, are set out in s.239 of the Insolvency Act 1986 and parts of s.240. The liquidator must establish that: the transaction was entered into within the six months before the onset of insolvency<sup>17</sup> or, if the respondent is a person connected with the company, within the two years prior to the onset of insolvency;<sup>18</sup> the company did something which had the effect of putting the recipient of the preference into a position which, in the event of the company entering insolvent liquidation, would be better than the position he would have been in had the thing not been done;<sup>19</sup> the company was influenced in deciding to enter into the impugned transaction by a desire to enable the recipient to have a preference;<sup>20</sup> at the time of, or as a result of, the giving of the preference the company was unable to pay its debts within the meaning of s.123.<sup>21</sup>

Section 239 does not apply in Scotland, which has an alternative preference provision, s. 243 of the Insolvency Act 1986. Section 243 provides that a person seeking to recover a payment as a preference must prove different elements. Perhaps the most notable point is that unlike in England and Wales, a transfer can be a preference even where there is no desire on the part of the company to provide a benefit to the creditor.

The fact that the conditions for a preference is different in England and Wales compared with Scotland is not important for the purposes of this paper. Whether a liquidator is able to bring, and succeed with, proceedings under s.172(3) when a preference has been given does not turn on the differences in the two jurisdictions. For ease of exposition reference will be made to s.239 but unless stated to the contrary it will also encompass s.243.

While an action under s.172(3) will be brought against the director(s) who caused the company to pay a preference, a claim under s.239 must be commenced against the creditor who received the alleged preference.

#### **IV Preferences and the Duty**

We now come to the question posed in this paper. If a creditor has been paid by a company in preference to other creditors before liquidation commenced, and at a time when the rule of law referred to in s.172(3) applies, is a liquidator able to take action against the director(s) under s.172(3) for making the payment?

One might ask why a liquidator would wish to rely on s.172(3) if a payment was a preference under s.239 and could be attacked under that provision. One reason is that a liquidator might not want to proceed against the creditor beneficiary of the payment as that person is

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<sup>17</sup> See Insolvency Act 1986, s.240(3).

<sup>18</sup> Insolvency Act 1986, s.239(2).

<sup>19</sup> Insolvency Act 1986, s.239(4)(b).

<sup>20</sup> Insolvency Act 1986, s.239(5).

<sup>21</sup> Insolvency Act 1986, s.240(2).

insolvent or close to it and so any judgment secured might be otiose. This was likely the reason for the liquidator in the leading English case of *West Mercia*<sup>22</sup> taking action for breach of the director's duty to take into account creditors' interests rather than pursuant to the precursor of s.239.

Another reason why a liquidator might proceed under s.172(3) in relation to a preference-type payment is that that while a creditor has been preferred, one or more of the conditions under s.239 are not able to be fulfilled. In such a case the liquidator may wish to turn to the directors and take action against them if they failed to consider the interests of the creditors when making the payment.

The following sections of the paper consider first, whether an action can be brought under s.172(3) against a director where the payment to a creditor, whether the director himself or herself or a third party, falls within s.239. It then examines whether an action under s.172(3) can succeed where the preferred payment does not meet the requirements for a preference under s.239. Finally, it considers two other issues that relate to a claim by a liquidator under s.172(3) in relation to preference-like payments. The first is whether the mere fact that proving a preference meets the conditions in s.239 can of itself establish a breach of s.172(3). The second issue is where there is evidence to suggest that a director failed to take account of creditors' interests in paying a creditor, but the director is impecunious or has absconded, can the liquidator take action against the recipient creditor even if s.239 cannot be satisfied?

### **1. Preferences Fulfilling Section 239 (or Section 243) Conditions**

Is a liquidator permitted to succeed against a director under s.172(3) where it is possible for the liquidator to establish a preference under s.239 and, therefore, he or she could recover against the creditor? The place to start is *West Mercia*.<sup>23</sup> D was the director of two companies, X and Y. X was the parent company of Y. At the relevant time both companies were in financial difficulty. X had a large overdraft that D had guaranteed and also there was a charge over its book debts. Y owed £30,000 to X. A few days before there was a meeting of the members of Y, which was going to consider a motion that Y wind up, D transferred the sum of £4,000 that had been paid to Y by one of its debtor to X's overdrawn bank account. On the liquidation of Y the liquidator sought both a declaration that D was guilty of misfeasance and breach of duty in relation to the transfer of the money to X, and repayment of the £4,000. This was even though the liquidator had a good case against X under the preference provision in Bankruptcy Act 1914.<sup>24</sup> At first instance, in the county court, the liquidator failed. He then appealed to the Court of Appeal. Dillon L.J., who gave the leading judgment with which the other members of the Court (Croom-Johnson L.J. and Caulfield J.) concurred, found that the payment to X constituted a fraudulent preference (under the Bankruptcy Act 1914). Moreover, the Court found that directors owe a duty to take account of creditors' interests when their company is insolvent and in this case D had

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<sup>22</sup> (1988) 4 B.C.C. 30

<sup>23</sup> The decision was approved of by Lord Mance in *Stone & Rolls Ltd (in liquidation) v Moore Stephens (a firm)* [2009] UKHL 39; [2009] 1 A.C. 1391 at [238].

<sup>24</sup> The events had occurred before the enactment of the Insolvency Act 1986.

acted in breach of the duty. So while a preference claim could have been established against X, a claim under the duty to take account of creditors' interests succeeded.

Reasonably recent cases confirm that a claim may be made under s.172(3) where a preference could have been successful under s.239. First, in *Re Agrave Ltd*<sup>25</sup> the Court was willing to make a declaration that the director was guilty of misfeasance (based upon a breach of the duty to consider the interests of creditors) as well an order under s.239. In *Re Cosy Seal Insulation Limited (in Administration)*<sup>26</sup> it was held that preferential payments made to the director himself and to a related company were breaches of the duty to take account of creditors, as well as being recoverable as a preference under s.239. The duty was also held to have been breached in both *Re Micra Contracts Ltd (in liquidation)*,<sup>27</sup> when the respondent director caused preference payments to be made to a related company and in *Ball v Hughes*,<sup>28</sup> when credits were made to directors' loan accounts. In these latter two cases the actions taken by the company were regarded as preferences within s.239.

The position seems to be the same in Scotland. In the recent case of *Caley Oils Ltd v Wood*,<sup>29</sup> Lord Clark said that: "The common law duty of directors in respect of creditors is not restricted to preferences and is therefore of broader scope than section 243."<sup>30</sup> This implies that if a liquidator had a claim that would fulfil the conditions under s.243, he or she could also make a claim under s.172(3). His Lordship said that claims under s.172(3) are not restricted to preferences, hence logically they must include preference type claims.

The next thing to ask is whether, for a s.172(3) claim to succeed, the payment has to benefit the director, as it did in *West Mercia*, or an associate. In *West Mercia* the director who was found liable had clearly paid the debt to benefit himself. Did *West Mercia* limit recovery to circumstances where the director has acted in self-interest? The comment of Dillon LJ that: "in my judgment Mr. Dodd was guilty of breach of duty when, *for his own purposes*, he caused the £4,000 to be transferred in disregard of the interests of the general creditors of this insolvent company"<sup>31</sup> (my emphasis) might suggest that a claim for a breach of the duty referred to in s.172(3) could only succeed where the director engaged in self-dealing. Yet that analysis is not consistent with the cases. In the oft-cited decision in *Re HLC Environmental Projects Ltd*<sup>32</sup> ("*HLC Environmental Projects*"), the respondent director sought to distinguish *West Mercia* on the basis that the Court only sought to permit a claim under the duty in relation to preferential payments made to benefit the director of the company who caused the payment to be made, whereas in *HLC Environmental Projects* there was no benefit to the directors.<sup>33</sup> John Randall Q.C. (sitting as a deputy judge of the High Court) rejected the distinction and he dismissed the argument that *West Mercia* was limited to cases where directors had paid preferences to themselves or associates. The deputy judge

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<sup>25</sup> Unreported, Mr N. Strauss Q.C., Ch. D, 25 June 2012.

<sup>26</sup> [2016] EWHC 1255 (Ch).

<sup>27</sup> [2016] B.C.C. 153

<sup>28</sup> [2017] EWHC 3228 (Ch), [2018] 1 B.C.L.C. 58.

<sup>29</sup> [2018] CSOH 42.

<sup>30</sup> [2018] CSOH 42 at [48]

<sup>31</sup> (1988) 4 B.C.C. 30, 33.

<sup>32</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337.

<sup>33</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [137]

did not think that the Court of Appeal intended to limit the scope of its comments,<sup>34</sup> and did not think that too much could be placed on the words “for his own purposes” used by Dillon L.J. and highlighted in the above quotation from the case.<sup>35</sup> The deputy judge felt that if the Court of Appeal had considered it was central to its decision that the director was the one in receipt of the payment the Court would have made it clear.<sup>36</sup>

Other decisions handed down both before and after *HLC Environmental Projects* adopt the same view. First, Hobhouse J. in *Berg Sons & Co Ltd v Adams*<sup>37</sup> said, after referring to *West Mercia* and noting that in that case the director abused his position for his own advantage, his Lordship said that: “but the same principle [prejudicing creditor interests] applies wherever it can be shown that those in charge of the affairs of a company or in control of it are acting contrary to the principles governing insolvency.”<sup>38</sup> A primary principle governing insolvency is that after payment of any creditors given priority by the Insolvency Act 1986,<sup>39</sup> the funds of a company in liquidation must be distributed *pari passu*. The *pari passu* principle requires creditors to be paid equally and rateably. Any preference, whether or not paid as a consequence of self-dealing by a director of the company paying the preference, will disturb a *pari passu* distribution as one creditor will receive more than the other creditors in that the preferred creditor is paid in full while the others have to make do with a dividend payment from the liquidator that will be less than 100p in the pound.<sup>40</sup>

In *Re Brian D Pierson (Contractors) Ltd*<sup>41</sup> Hazel Williamson Q.C. (sitting as a deputy judge of the High Court) said that if she were incorrect about her finding that the respondent director had not granted a preference within s.239 to an associate then the question would arise whether the giving of a preference in those circumstances would be a misfeasance committed by the directors.<sup>42</sup> This suggests that a claim for breach of duty may be instituted if a preference satisfied the conditions within s.239.

In *Re Cityspan Ltd*<sup>43</sup> three repayments of directors' loans were made in the month prior to the commencement of insolvent liquidation proceedings, two to the director who authorised them and one to another director. The director authorising the payments was held to have been in breach of the duty in respect of all three payments, even though one of the payments was not for his benefit.

Thus, it appears plain that a liquidator is able to claim recovery from a director any payment that is a preference within s.239 if the liquidator is able to discharge the requirements of a breach of the duty and even if the preference is not designed to benefit the director. This is understandable when one considers that the director in making preferential payments

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<sup>34</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [139]

<sup>35</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [139]

<sup>36</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [139]

<sup>37</sup> [1992] B.C.C. 661.

<sup>38</sup> [1992] B.C.C. 661 at 679

<sup>39</sup> Under Insolvency Act 1986, s.175 and Sch. 6.

<sup>40</sup> See “Insolvency Law and Practice” Cmnd 8558 (HMSO, 1982) (“the Cork Report”) at [1241].

<sup>41</sup> [1999] B.C.C. 26

<sup>42</sup> [1999] B.C.C. 26, 46

<sup>43</sup> [2007] EWHC 751 (Ch); [2008] B.C.C. 60; [2007] 2 B.C.L.C. 522.

commits what some authorities refer to as a “fraud on the creditors.” For instance, in *West Mercia*<sup>44</sup> Dillon L.J. said that the director:

“had been expressly told not to deal with the company's bank account, and Mr. Dodd [the defendant director] had, in *fraud of the creditors* of the company, made the transfer to the Dodd company's account for his own sole benefit...”<sup>45</sup>  
(my emphasis)

Obviously the fraud in this context is equitable fraud. According to Gummow J. in *Re New World Alliance*<sup>46</sup> a breach of the duty which is the subject of this paper was similar to that found in cases involving fraud on the minority.<sup>47</sup>

It might be said that directors are perpetrating a fraud on the creditors in situations where they make payments to creditors as they are carrying out an informal liquidation,<sup>48</sup> that is, distributing company funds to whomsoever the directors choose and not in accordance with insolvency law. In *HLC Environmental Projects*<sup>49</sup> John Randall Q.C. was critical of the respondent director in choosing which creditors to pay and which to leave exposed to a risk of non-payment at a time when the director had to take into account the company's creditors.<sup>50</sup> Later, Registrar Barber (as she then was) in *Re Micra Contracts Ltd* appeared to outlaw the notion of directors carrying out an informal liquidation by paying off selected creditors and ignoring the interests of others.<sup>51</sup>

In *GHLM Trading Ltd v Maroo*<sup>52</sup> (“*Maroo*”) Newey J. (as he then was) said that:

“Where creditors’ interests are relevant, it will similarly, in my view, be a director’s duty to have regard to the interests of the creditors as a class. If a director acts to advance the interests of a particular creditor, without believing the action to be in the interests of creditors as a class, it seems to me that he will commit a breach of duty.”<sup>53</sup>

It can be inferred from Newey J.’s comment that in paying one creditor and not all of the creditors in the class the director’s action offends the *pari passu* principle, unless the director was, in doing so, acting in the interests of the creditors as a whole.<sup>54</sup>

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<sup>44</sup> [1988] 4 B.C.C. 30.

<sup>45</sup> [1988] 4 B.C.C. 30 at 33.

<sup>46</sup> (1994) 122 A.L.R. 531 at 550.

<sup>47</sup> For instance, see *Cook v Deeks* [1916] 1 A.C. 554 for an example of a fraud on the minority.

<sup>48</sup> A term used by Registrar Barber in *Re Micra Contracts Ltd* [2016] B.C.C. 153 at [103].

<sup>49</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337.

<sup>50</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [106].

<sup>51</sup> [2016] B.C.C. 153 at [103].

<sup>52</sup> [2012] EWHC 61; [2012] 2 B.C.L.C. 369.

<sup>53</sup> [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [168].

<sup>54</sup> It should be noted that it might be inferred from the statement of Hart J. in *Knight v Frost* [1999] B.C.C. 819 that “It is through the mechanism of liquidation that the creditors are protected...” (at 834) that he would not agree with the line taken in cases such as *HLC Environmental Projects* and *Re Micra Contracts Ltd* [2016] B.C.C. 153. It must be appreciated that Hart J. was dealing with a derivative action brought by shareholders rather than action brought by a liquidator.

We have seen already<sup>55</sup> that in *Berg Sons & Co Ltd v Adams*<sup>56</sup> Hobhouse J. stated that when a company is insolvent the duty of the directors is to preserve the assets of the company and not to act contrary to the rules of insolvency.<sup>57</sup> A rule of insolvency might be a reference to the pari passu rule and directors are not to engage in doing something that amounted to an informal liquidation of the company.

An informal liquidation might be seen as a fraud on the creditors because if the company is insolvent (on a balance sheet or cash flow basis) the creditors are entitled to petition to wind up the company and participate in a distribution of the company's funds, and if the directors act to the detriment of one or more of the creditors then it could be said that they are frustrating "the creditors' inchoate entitlement,"<sup>58</sup> namely participating in a distribution of the company's assets. Furthermore, the courts have made it clear in other contexts that there can be no liquidation except that which is provided for by statute,<sup>59</sup> thus informal liquidations are not permitted.

## 2. Preferences Not Fulfilling Section 239 Conditions

The next question to address is whether an action can be brought under s.172(3) against a director in relation to a payment that prefers a creditor, but it is not one that is within s.239, and thus the payment to the creditor is not technically a preference for legislative purposes. While it is not within s.239, a creditor still receives more than other creditors and the effect is, therefore, the same. This represents more of a tricky issue as there appears to be some inconsistency in the case law. Older cases seem to be against allowing a claim for breach of duty where there is repayment to a creditor and the conditions in s.239 are not fulfilled. On the other hand, most of the more recent cases that have been concerned with preference-like payments have permitted claims under s.172(3).

It might be thought that if a payment does not fall within what the law classifies as a preference then a liquidator has done nothing wrong – a debt has been simply paid off – and, adopting the comment of Park J. in *Singer v Beckett; Re Continental Assurance Co of London Plc (in liquidation)*<sup>60</sup> ("Singer") a liquidator should not be able to get by the back door what cannot be obtained by way of the front door. Park J. held that one of the conditions of s.239 was not met and that it would be entirely wrong to use a misfeasance action based on a breach of the duty to take into account creditors' interests in order to get round the liquidator's inability to use the statutory provision. Earlier in *Knight v Frost*<sup>61</sup> ("Knight") Hart J. said that he did not think that the authorities supported the argument that a director was in breach of the duty if a payment was made to a creditor when the company was insolvent, as *West Mercia* had involved a fraudulent preference within the precursor of s.239, and *West Mercia* was:

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<sup>55</sup> See the text accompanying fns 37 and 38.

<sup>56</sup> [1992] B.C.C. 661.

<sup>57</sup> [1992] B.C.C. 661 at 679.

<sup>58</sup> Armour, "Avoidance of Transactions as a 'Fraud on Creditors' at Common Law" in Armour and Bennett, *Vulnerable Transactions in Corporate Insolvency* (Oxford, Hart Publishing, 2003) at 318.

<sup>59</sup> *London Joint City & Midland Bank v Herbert Dickinson Ltd* [1922] W.N. 13 at 14

<sup>60</sup> [2007] 2 B.C.L.C. 287.

<sup>61</sup> [1999] 1 B.C.C. 819.

“not authority for the proposition that a director who for his own purposes causes the company to prefer one of its creditors over another outside that statutory period is liable to replace the money at the suit of the company.”<sup>62</sup>

These comments were all obiter as the case involved a shareholder bringing a derivative action for breach of directors’ duties, but not including the duty to take account of creditor interests.

In *Facia Footwear Ltd (in administration) v Hinchliffe*<sup>63</sup> a claim was made that there had been a breach of duty in the making of a preference type payment, but Scott V-C said that as there was no point taken about a fraudulent preference, “it seems to me impossible to describe the authority given for the payment as misfeasance.”<sup>64</sup> This suggests that as no preference under the Insolvency Act was involved misfeasance could not have occurred. In *Maroo Newey J.* said, before referring to *Singer* and *Knight*, that: “The Courts have been less ready to impose liability on a director if the circumstances are such that no statutory remedy [under the Insolvency Act] would be available.”<sup>65</sup>

Nevertheless, there are cases, and these represent the majority of recent cases that have dealt with the issue, indicating clearly that a liquidator can challenge preferences that do not fall squarely within s.239. In *HLC Environmental Projects* the liquidator claimed a breach of duty in relation to payments made to creditors, but did not plead a preference within s.239, although he did try to add this, unsuccessfully, to the pleadings at a later date. Nevertheless, John Randall Q.C. found for the liquidator and he did not consider whether the elements of s.239 could have been satisfied in relation to the payments made by the respondent director to pay off debts. The deputy judge was mainly focused on the issue of whether the director considered creditor interests in making the payments that were challenged.<sup>66</sup>

In *Re Cosy Seal Insulation Ltd (in administration)*<sup>67</sup> H.H. Judge Behrens (sitting as a High Court judge) was willing to make an order relating to misfeasance even though he was not convinced some of the payments were preferences under the Insolvency Act.<sup>68</sup> In a much earlier case, *Berg Sons & Co Ltd v Adams*,<sup>69</sup> Hobhouse J. appeared to agree with the line taken in the cases just mentioned. His Lordship said that:

“The *West Mercia* case was a clear case of a director abusing his position for his own advantage but the same principle applies wherever it can be shown that those in charge of the affairs of a company or in control of it are acting contrary to the principles governing insolvency.”<sup>70</sup>

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62 [1999] 1 B.C.C. 819 at 834.

63 [1998] 1 B.C.L.C. 218

64 [1998] 1 B.C.L.C. 218 at 229.

65 [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [167]

66 [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [89].

67 [2016] EWHC 1255 (Ch); [2016] 2 B.C.L.C. 31.

68 [2016] EWHC 1255 (Ch); [2016] 2 B.C.L.C. 31 at [167].

69 [1992] B.C.C. 661.

70 [1992] B.C.C. 661 at 679.

As stated earlier, the reference to ensuring the enforcement of the principles governing insolvency suggests that the judge would say that any preference payment was a breach of the duty as it would disturb the principles governing insolvency, which would include the *pari passu* principle.

It is notable that the recent cases do not refer to the older cases and when they do it is not in relation to the issue that this section of the paper is addressing, and this is surprising as one would have expected the respective counsel for director respondents to have referred to these older cases in order to support the defence. They may have done so, of course, and the respective judges just did not feel that it was necessary to refer to the cases.

One recent decision, *Maroo*, is somewhat problematic in an attempt to discern an answer to the issue at hand. There are comments by Newey J. that suggest that he would favour allowing a breach of duty claim where a preference not fulfilling s.239 had been granted. He said that:

“Where creditors' interests are relevant, it will similarly, in my view, be a director's duty to have regard to the interests of the creditors as a class. If a director acts to advance the interests of a particular creditor, without believing the action to be in the interests of creditors as a class, it seems to me that he will commit a breach of duty. Whether or not section 239 of the Insolvency Act 1986 (dealing with preferences) is in point cannot be determinative...the fact that the conditions laid down by section 239 are not all met should not, of itself, preclude a finding of breach of duty.”<sup>71</sup>

This suggests, therefore, that if a director were to make a preference payment, even though s.239 did not apply, it could still form the basis for a breach of s.172(3) provided that the liquidator could demonstrate that the director did not act in the interests of the creditors in making that payment.

However, later in his judgment his Lordship said that:

“It seems to me that a company seeking redress in respect of a ‘preference’ to which section 239 does not apply is likely to need to show (a) that it has suffered loss, (b) that the director has profited (so that the ‘no profit’ rule operates) or (c) that the transaction in question is not binding on the company. In a typical case, the first of these may be impossible: if the ‘preference’ involved the discharge of a debt, the company's balance sheet position is likely to be unaffected.”<sup>72</sup>

This last comment appears to place very substantial parameters on challenging a payment that is not within s.239. Yet this does not seem to be consistent with the fact that in the first quotation above he refers to the fact that any actions of directors must advance the interests of the class, so one might conclude that any preference-like payment, whether within s.239 or not, that failed to advance the interests of creditors could found a breach

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<sup>71</sup> [2012] EWHC 61 (Ch); [2012] 2 B.C.L.C. 369 at [168].

<sup>72</sup> [2012] EWHC 61 (Ch); [2012] 2 B.C.L.C. 369 at [169]

of duty action.

This leads on to asking whether a payment that does not meet the threshold conditions of s.239 should be able to be challenged? On one view it can be argued that it should not. The legislature has seen fit for many years to provide that a payment of a creditor, which is not outlawed by the law generally, is only able to be adjusted where it falls within the relevant preference provision. The reason for this has not been indicated in the legislation or any government publication, and not even in the Cork Report, which was the report of a committee established to conduct a comprehensive review of insolvency law in 1979. Walters expressly acknowledges the fact that there is no defined policy.<sup>73</sup> Other commentators have said that the law on preferences attempts to balance the competing demands of ensuring the scheme of distribution of assets is kept intact on the one hand, and that contractual certainty is maintained on the other.<sup>74</sup> The concept of the preference grew up in the eighteenth century, being formulated, it would seem, by Lord Mansfield in 1768<sup>75</sup> and it was imported into the Companies Act 1862,<sup>76</sup> but with no evident consideration of the rationale for the avoidance of preferences. Notwithstanding this, it may be argued that the preference provision exists essentially to prevent an informal liquidation of a company's assets, given the fact that the rationale behind allowing certain preferences to be impugned is to ensure that the company's assets are distributed according to the liquidation rules in the Insolvency Act 1986.<sup>77</sup>

It is often said that the conditions for establishing a preference exists to ensure that commercial certainty is maintained.<sup>78</sup> That is, a creditor knows that if a payment does not fulfil the terms of s.239 then it cannot be recovered and he can commit the funds to paying off his creditors or for other purposes. This sounds very convincing, but in reality there is little certainty even taking into account the conditions in s.239. The creditor does not know on receipt of the payment whether the debtor company will end up in liquidation within six months of payment, whether the company was insolvent at the time of payment or whether a liquidator is likely to initiate proceedings to attack the payment. Certainty is simply unobtainable on payment and for some time thereafter.

It is contended that the better view is that a liquidator is able to bring proceedings under s.172(3) where a payment is made that is not within s.239. The reason is that as with the situation where a payment falls within s.239, it can be said that the director is committing a

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<sup>73</sup> Walters, 'Preferences' in Armour and Bennett, *Vulnerable Transactions in Corporate Insolvency*, at 138.

<sup>74</sup> For example, Parry, *Transactional Avoidance in Insolvencies* (Oxford, OUP, 2001) at 15. Also, see L Ponoroff, 'Evil Intention and Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More time' [1993] *Wisconsin Law Review* 1439 at 1444-1445.

<sup>75</sup> *Worsley v Temple* (1768) 4 Burr. 2235.

<sup>76</sup> See, Cork Report, at [1245]; Weisberg, "Commercial Morality, the Merchant Character and the History of the Voidable Preference" (1986) 39 *Stanford Law Review* 3; Countryman, "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 *Vanderbilt Law Review* 713; Glenn, "The Diversities of the Preferential Transfer: A Study in Bankruptcy History" (1930) 15 *Cornell Law Quarterly* 521.

<sup>77</sup> Simply this involves the paying of preferential debts (e.g. employees' wages) followed by the payment of unsecured creditors. See the Cork Report, at [1241].

<sup>78</sup> For example, see Keay, *Avoidance Provisions in Insolvency Law* (Sydney, Law Book Co, 1997) at 366; de Weijs, "Towards an objective European Rule on Transaction Avoidance in Insolvencies" (2011) 20 *International Insolvency Review* 219 at 226.

fraud on the creditors. The director is selecting who to pay and who not to pay at a time when the company is in financial distress, and when the director should be taking into account the interests of creditors. It is contended that the critical issue is: is the payment in the best interests of the creditors? It is clearly in the interests of the creditor paid, but it is not in the interests of the creditors as a whole that one creditor is paid in full and other creditors are not paid at all, except where it is beneficial for all creditors to pay a creditor, such as to ensure that the creditor continues to supply the company. Whether or not the payment falls within s.239 should not be determinative. The courts have seen fit, and this has effectively been approved of with the enactment of s.172(3), to permit liquidators to recover sums paid by directors when they are not acting in the interests of the creditors as a whole at a time when a company is insolvent or near to it. If a director can make out a case that the payment was made to benefit creditors, or at least that it would not prejudice creditors then fine, the payment should not be able to be challenged. Arguably there is as great a case for permitting a liquidator to recover a preference-like payment under s.172(3) as there is under s.239. In relation to the latter the debtor has been influenced by a desire to give the creditor a preference. Under s.172(3) there must be evidence that the director of the debtor did not take into account the interests of the creditors. Also, unlike with a claim under s.239, a liquidator claiming a payment as a breach of duty is not able to rely on any presumption where the creditor is connected to the debtor company. The liquidator still has to establish the same case under s.172(3) as with a non-connected party.

The conclusion one can make from the above analysis is that there is inconsistency in the case law. Certainly, leaving aside parts of Newey J.'s judgment, the most recent case law favours permitting challenges against preference payments falling outside of s.239 as a breach of duty provided that the claimant can establish the fact that the preference did not advance the interests of the creditors. This seems sensible in that any preference-like payment, whether it falls under s.239 or not, will prejudice the general body of creditors, and not permitting a challenge under s.172(3) allows directors to engage in an informal liquidation based on their own choices.

If the conclusion in the last paragraph is correct then it has potentially wide ramifications. Liquidators often refrain from taking proceedings in relation to payments made to creditors because they cannot be assured of establishing all of the conditions in s.239. They particularly have difficulty in establishing that the payment was influenced by a desire to give the creditor a preference.<sup>79</sup> Proceedings are more often taken against creditors connected with the company as the liquidator is not required to establish this condition; in fact the debtor company is presumed to have been influenced by a desire and the creditor has to rebut that presumption. The above analysis suggests that liquidators do not have to worry about taking what might be a risky action against the creditor; they can proceed against the director authorising payment provided they can establish that the director did not consider the interests of the creditors when making the payment.

### **3. Other Relevant Issues**

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<sup>79</sup> Keay, *McPherson and Keay's Law of Company Liquidation* (London, Sweet and Maxwell, 4<sup>th</sup> ed, 2017) at 704-715.

There are two other connected issues worthy of consideration. The first is whether the mere fact that proving a preference meets the conditions in s.239 can of itself establish a breach of s.172(3). In the old case of *Re Wincham Shipbuilding, Boiler, and Salt Company Poole, Jackson, and Whyte's Case*<sup>80</sup> the Court of Appeal said that there was no duty imposed on the directors not to pay a debt of the company, for which they were themselves liable, in priority to other debts, *unless it constituted a fraudulent preference*.<sup>81</sup> (my emphasis) This decision was made under much earlier insolvency provisions, but applying it to today's legislation it seems to suggest that if the conditions of s.239 are fulfilled then a liquidator would be entitled to take action against the director.

In far more recent times it was argued in *Re Brian D Pierson (Contractors) Ltd*<sup>82</sup> by counsel for the liquidator, relying on *West Mercia*, that proving a payment was within s.239 meant that the liquidator had proven a breach of duty not to account for the interests of creditors. However, the deputy judge hearing the case rejected that contention. She said that the preference in *West Mercia* consisted of acts by the director that was found to be a conscious application of the company's funds for the known purpose of preferring his own interests, and this was a misapplication of those funds. However, she did not think that merely establishing that there was a preference voidable at law under s. 239 was sufficient to find the directors necessarily committed a breach of duty of the type provided for in *West Mercia*. The deputy judge said:

“That would be tantamount to saying that directors simply have a duty not to allow s. 239 to be breached. In my judgment this is too sweeping. It must be a matter of fact, in any particular case, whether the acts of a director which are held to constitute the giving of a preference are also, in their own right, acts which amount to misfeasance and breach of duty. This test will be applied bearing in mind that in the case of imminent liquidation the directors owe duties to creditors as well as shareholders.”<sup>83</sup>

In this case a preference payment had been made to a company employee and the liquidator was claiming that this constituted a breach of duty. The employee was a party connected to the company and thus it was presumed under the Insolvency Act that in making the payment the company had been influenced by a desire to grant the employee a benefit over the other creditors. The deputy judge said that if the payment was only a preference within s. 239 solely by reason of the statutory presumption, she would not have been prepared to hold that this compelled the conclusion that it was also a breach of duty on the part of the directors.<sup>84</sup> Thus the deputy judge's view was that merely proving that a payment is a preference for the purposes of s.239 will not suffice to establish a breach of duty. Clearly something more was needed. It is assumed that it is demonstrating that in making the payment the director did not take into account the creditors' interests.

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<sup>80</sup> (1878) 9 Ch. D 322.

<sup>81</sup> (1878) 9 Ch. D 322 at 327.

<sup>82</sup> [1999] B.C.C. 26.

<sup>83</sup> [1999] B.C.C. 26 at 46.

<sup>84</sup> [1999] B.C.C. 26 at 46.

Newey J. in *Maroo* implicitly agreed with this approach. His Lordship said that in deciding whether a payment was a breach of duty was something that was not totally dependent on the application of s.239.<sup>85</sup> Thus, establishing the fact that a preference falls under s.239 does not, of itself, mean that there is a breach of the duty to account for creditor interests. One can envisage the case where the payment was made to a creditor for the benefit of creditors as a whole, such as where the payment was needed so that the creditor would agree to continue to supply goods to the company that were critical to the company carrying on business,<sup>86</sup> and thus it should not be a breach of a duty.

The second issue that is related to preferences and warrants consideration is where there is evidence that suggests a director failed to take account of creditors' interests in paying a creditor, but the director is impecunious or has absconded. Can the liquidator instead succeed against the recipient creditor even if s.239 cannot be satisfied? In this type of situation there might be two arguments that a liquidator pursues in challenging the payment. The first involves the creditor being liable for accessory liability, a liability, derived from trusts law, fixed on someone who is a third party to a breach of duty.<sup>87</sup> A person, in the position of a creditor, may be liable for either dishonestly assisting in a breach ("dishonest assistance") or knowingly receiving property as a result of a breach ("knowing receipt"). To succeed against a party for the former, dishonesty has to be established.<sup>88</sup> Third parties are liable for dishonest assistance even if they did not realise that what was done by the director was a breach of duty provided that they knew or suspected that their involvement in the activity was dishonest.<sup>89</sup> It suffices if the assister knows or suspects that the transaction is such that it makes involvement in it dishonest.<sup>90</sup> The law on the issue of what dishonesty entails in this context has "gone through tortuous judicial revisions and clarifications,"<sup>91</sup> but it is now settled that the relevant standard is the ordinary standard of honest behaviour.<sup>92</sup> As far as knowledge goes, in *Madoff Securities International Ltd (in liq) v Raven*<sup>93</sup> the judge said that what the assister actually knew, understood, believed or suspected at the time of her impugned conduct was critical. In this context it is not necessary for the assister to know all the details of the whole design, but must know in broad terms what the design was.<sup>94</sup>

Knowing receipt is all about a party receiving company property. In contrast to dishonest assistance, there is no need to establish dishonesty,<sup>95</sup> but there is need to establish that trust property was received. Dishonest assistance may well not focus on the property that is controlled by the directors, but dealing with trust property is at the heart of a claim for

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<sup>85</sup> [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [168].

<sup>86</sup> Of course, continuing the business and running up further debt might not always be in the interests of the creditors.

<sup>87</sup> They derive from *Barnes v Addy* (1874) 9 Ch. App. 244.

<sup>88</sup> *Barlow Clowes International Ltd v Eurotrust Ltd* [2005] UKPC 37; [2006] 1 W.L.R. 1497.

<sup>89</sup> *Agip (Africa) Ltd v Jackson* [1990] Ch 263 at 295; *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm).

<sup>90</sup> *Abou-Ramah v Abacha* [2006] EWCA Civ 1492; [2007] 1 Lloyd's Rep 115, [39]; *Barlow Clowes International Ltd (In Liquidation) v Eurotrust International Ltd* [2005] UKPC 37; [2006] 1 WLR 1476 at [28].

<sup>91</sup> Lee, 'Dishonesty and bad faith after Barlow Clowes: Abou-Rahmah v Abacha' [2007] J.B.L. 209 at 209.

<sup>92</sup> See *Starglade Properties Ltd v Nash* [2010] EWCA Civ 1314.

<sup>93</sup> [2013] EWHC 3147 (Comm) at [353].

<sup>94</sup> *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1506].

<sup>95</sup> *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch 437 at 450.

knowing receipt. A person is only liable for knowing receipt if his state of knowledge would make it unconscionable for him to retain the benefit of the receipt.<sup>96</sup> It has been indicated that the test for knowledge in knowing receipt is lower than for dishonest assistance.<sup>97</sup>

While it is not able to be ruled out totally, it is unlikely in the preference-type case that there would be a successful claim based on dishonest assistance. In the large majority of cases, the most a creditor might do is to press for payment of the debt owed and even make threats, and it is likely that a court would not see it as dishonest for a creditor to do this where a valid debt is owed. To be liable creditors would need to know broadly that the director is doing something which she is not entitled to do,<sup>98</sup> and for the most part that is not likely to be the case.

Reliance on knowing receipt seems, prima facie, to be more promising given that dishonesty does not need to be proved. It has been suggested by one commentator<sup>99</sup> that knowing receipt is not likely to be the basis for a claim as the Court of Appeal stated in *Novoship (UK) Ltd v Mikhailuyuk*<sup>100</sup> said that there must be receipt of trust property. This is of course correct, but surely, a creditor in the kind of situation we are considering would be in receipt of trust property, namely company funds. This analysis appears to be consistent with what H.H. Judge Simon Barker Q.C. (sitting as a High Court judge) said in *Northampton Borough Council v Anthony Michael Cardoza*<sup>101</sup> when dealing with a s.172(3) claim in relation to a payment that was a preference. It also appears consistent with the comments of the deputy judge in *HLC Environmental Projects*<sup>102</sup> where he referred to a payment from the company as analogous to denuding the trust fund. But in any event, relying on knowing receipt is problematic as it would seem from what the Court of Appeal said in *Bank of Credit and Commerce International (Overseas) Ltd v Akindele*<sup>103</sup> actual knowledge of the breach of duty must be established.<sup>104</sup> Thus this is likely to make it difficult to challenge a payment made to a creditor who is not associated with the company or its officers for some of the reasons mentioned above in respect of dishonest assistance. One can envisage a situation where creditors with considerable power might be aware of the company's financial plight through various avenues, including talking to the directors, and who might be said to engage in knowing receipt, but this is not likely to be the case for most creditors.<sup>105</sup>

An alternative argument that a liquidator might be able to run, and that would lead to the same result, is that mentioned by Newey J. in *Maroo*. The judge said that the payment to a

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<sup>96</sup> *Houghton v Fayers* [2000] 1 B.C.L.C. 511; *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch. 437.

<sup>97</sup> *Otkritie International Investment Management Ltd v Urumov* [2014] EWHC 191 (Comm) at [81].

<sup>98</sup> *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638, [1505] – [1506].

<sup>99</sup> Van Zwieten at 407 (n.166).

<sup>100</sup> [2014] EWCA Civ 908; [2015] Q.B. 499.

<sup>101</sup> [2019] EWHC 26 (Ch) at [188].

<sup>102</sup> *HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [142].

<sup>103</sup> [2001] Ch. 437.

<sup>104</sup> [2001] Ch. 437 at 450–452. Constructive knowledge was sufficient according to some previous English cases, such as the Court of Appeal decision in *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1985] 3 All E.R. 52.

<sup>105</sup> An example is found in the Australian case of *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239.

creditor might not be binding on the company as ordinary agency principles indicate that a company can disavow a contract which:

“a director has caused it to enter into if (a) the director was acting in his own interests rather than those of the company, its members or (where appropriate) its creditors as a class and (b) the other party to the contract had notice of the director's breach of duty.”<sup>106</sup>

Thus, except where there is agreement to the contrary, authority to act as agent includes only authority to act for the benefit of the principal<sup>107</sup> and “no act done by an agent in excess of his actual authority is binding on the principal with respect to persons having notice that in doing the act the agent is exceeding his authority”.<sup>108</sup> The judge went on to say that he thought that the better view was where a director has caused her company to enter into a contract so as to forward her own interests, and not in the interests of the creditors as a class, and the other contracting party had notice of that fact, the contract is void.<sup>109</sup> A creditor might well perceive that he is receiving a benefit others are not receiving and so the payment is not in the best interests of the creditors as a whole. Yet, it is perhaps arguable that the analysis of the judge is questionable or at least not relevant to the kind of transactions with which the paper is concerned. The payment by a director of a debt owed merely performs the contract that the company is bound to perform already, assuming the contract was formed properly so one would expect implied authority to exist. Where his Lordship’s reasoning might be appropriate is in relation to the fact that an agent might not have authority to perform an existing contract, which is a distinct issue.<sup>110</sup> In any event the judicial discussion does not include consideration of whether the principal is bound by the director because she has ostensible authority, namely where a principal gives the impression that the agent has actual authority and the third party was not on inquiry as to the agent’s lack of actual authority.<sup>111</sup>

Even if the approach mentioned by Newey J. is correct then given what the judge said in the above quotation, a liquidator would have to establish that the director(s) who authorised the payment was acting in her own interests and the creditor was aware of this. This could well rule out its usefulness, for the most part, where the payment was made to an independent creditor. Nevertheless, there might still be scope for a liquidator to succeed if it could be established that a payment was made by a director who did not have authority to make the payment even if he or she was not acting in self-interest as, according to Stafford and Ritchie, the case law leads to the conclusion that if a director pays company funds for which he or she had not authority, a restoration order may be made whether or not the director was doing so for self-interest.<sup>112</sup>

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<sup>106</sup> [2012] EWHC 61 (Ch); [2012] 2 B.C.L.C. 369 at [170].

<sup>107</sup> [2012] EWHC 61 (Ch); [2012] 2 B.C.L.C. 369 at [170], and citing *Bowstead & Reynolds on Agency*, 19th ed., at [3–007].

<sup>108</sup> [2012] EWHC 61 (Ch); [2012] 2 B.C.L.C. 369 at [170] and citing *Bowstead & Reynolds on Agency* at [8–049].

<sup>109</sup> [2012] EWHC 61 (Ch) at [171].

<sup>110</sup> Conaglen and Nolan, “Contracts and knowing receipt: principles and application” (2013) 129 L.Q.R. 359 at 364.

<sup>111</sup> Conaglen and Nolan at 363 and referring to *Bowstead and Reynolds on Agency* (2010), at [8-013].

<sup>112</sup> A. Stafford and S. Ritchie, *Fiduciary Duties* (Bristol, Jordans, 2<sup>nd</sup> ed, 2015) at [9.163]

If a liquidator succeeded on either of the aforementioned bases and the creditor was ordered to repay the money to the company, the creditor would retain a right to prove in the company's liquidation for the debt owed.<sup>113</sup> The benefit for creditors as a whole in succeeding against the creditor would be that the creditor would only be entitled to receive what all the other creditors in his class received; that will normally be far less than 100p in the pound.

### **V Loss to the Company?**

Only the company is able to bring proceedings under s.172(3), whatever the alleged breach, as the duty is owed to the company and not to the creditors or anyone else. This was the case at common law just as it under the Act.<sup>114</sup> There were some suggestions in dicta in a couple of cases in the 1980s<sup>115</sup> that directors might owe a duty to creditors, thus allowing creditors to bring proceedings in their own right, but that view has not been pursued with any vigour and has never been affirmed by the courts.<sup>116</sup> Any action will have to wait until the company enters liquidation for a liquidator is able to initiate proceedings under s.172(3) for the company as she stands in the shoes of the company when a liquidation commences.

A problem that has been identified with a claim in relation to a preference payment is that the liquidator has no valid claim because the company has not suffered any loss; the company's net position is unchanged after the payment. The loss, if any, has been suffered by the general body of creditors. This was explained in *Singer*<sup>117</sup> where Park J. said:

“Because the duty is owed to the company, any loss, if it is going to be recoverable by way of an action for misfeasance, must be loss suffered by the company. However, the payment by Continental of its liabilities to IATA and ABTA did not cause any loss to Continental. It may have caused loss to the creditors other than IATA and ABTA, but it did not cause any loss to the company.”<sup>118</sup>

In *Maroo*,<sup>119</sup> Newey J. said that if the “preference” which the liquidator is seeking to claim under s.172(3) involved the discharge of a debt, the company's balance sheet is likely to be unaffected.<sup>120</sup>

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<sup>113</sup> *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337; *GHLM Trading Ltd v Maroo* [2012] EWHC 61; [2012] 2 B.C.L.C. 369.

<sup>114</sup> See, s.170(4).

<sup>115</sup> For example, *Winkworth v Edward Baron Development Co Ltd* [1986] 1 W.L.R. 1512 at 1526, per Lord Templeman.

<sup>116</sup> In fact the Australian High Court in *Spies v R* [2000] HCA 43. 201 C.L.R. 603 expressly dismissed such an action.

<sup>117</sup> [2007] 2 B.C.L.C. 287; [2001] B.P.I.R. 733

<sup>118</sup> [2007] 2 B.C.L.C. 287; [2001] B.P.I.R. 733 at [448]. This position had also been taken earlier in *Berg Sons & Co Ltd v Adams* [1992] B.C.C. 661.

<sup>119</sup> [2012] EWHC 61; [2012] 2 B.C.L.C. 369.

<sup>120</sup> [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [169].

Similarly, where the respondent directors have been paid sums due to them it can be contended that they have not profited at the expense of the company as they were entitled to be paid what was owing to them. Again, it is the general body of creditors that is likely to have suffered in that one or more creditors have been paid more than what the other creditors will receive in the liquidation.

Yet the above reasoning has not stopped judges from ordering repayment where there has been a breach of the duty in relation to the payment of a preference. The classic case is *West Mercia*. Importantly in that case Dillon L.J., referred to the fact that at first instance the judge, while of the view that the respondent director had acted improperly, held that the director was not liable as he had used company assets merely to pay in part a debt owed by the company. Dillon L.J. remarked that what the judge had said might apply to a solvent company, but not to an insolvent one and he reversed the judge.<sup>121</sup> Critically, there was no loss to the company in this case as the respondent director was paying off a creditor. None of the cases that have claimed that a liquidator cannot succeed under s.172(3) in relation to a preference have successfully addressed the decision in *West Mercia*. In *Berg Sons & Co Ltd v Adams*,<sup>122</sup> for instance, Hobhouse J. glossed over it.<sup>123</sup> He and Hart J. in *Knight*<sup>124</sup> merely stated that in *West Mercia* the liquidator succeeded because the payment was a fraudulent preference, but they did not note that there was no loss to the company because the director was paying off a debt owed.

Besides *West Mercia* there have been several cases, primarily in recent years, where courts have found for the liquidator against a director who has granted a preference, and then ordered relief. For instance,<sup>125</sup> in *HLC Environmental Projects* the deputy judge ordered the respondent director to repay to the company (then in liquidation) both the amount he had received by way of payment for the sum he was owed and the amount that he paid out of company funds to a third party who was owed a debt by the company. The deputy judge said: "There is, in my judgment, no legal obstacle to relief being granted here in the form which the applicants primarily seek, and I consider the grant of such relief to be just and appropriate on the facts..."<sup>126</sup> An even more recent instance where relief was ordered is the case of *Caley Oils Ltd v Wood*<sup>127</sup> where Lord Clark actually addressed the loss issue when he said that:

"it is not in my view necessary for the pursuers to prove that the Company has suffered a loss in the conventional sense. The funds available to the Company to meet the claims of the general body of creditors were depleted. The director benefited, in the sense that he received payment in full. On restoration of the sums, if it is established that he is a creditor, he can rank accordingly. It is in my view a sufficient basis for restoration to be due by the defender that the payment

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<sup>121</sup> *West Mercia* (1988) 4 B.C.C. 30 at 32.

<sup>122</sup> [1992] B.C.C. 661.

<sup>123</sup> [1992] B.C.C. 661 at 79.

<sup>124</sup> [1999] B.C.C. 819 at 834.

<sup>125</sup> Other instances are *Re Mlcra Contracts Ltd* [2016] B.C.C. 153 at [116]; *Re Cityspan Ltd* [2007] EWHC 751 (Ch); [2008] B.C.C. 60; *Re Algrave Ltd* (unreported, Mr N. Strauss Q.C., Ch. D, 25 June 2012) at [1], [18], [20]; *Caley Oils Ltd v Wood* [2018] CSOH 42 at [68]; *Ball v Hughes* [2017] EWHC 3228 (Ch).

<sup>126</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [145].

<sup>127</sup> [2018] CSOH 42

was made, on insolvency, by the Company to the director himself and that he caused the misapplication of the funds... a loss was suffered in the sense that funds left the Company when insolvent, to the benefit of the defender, against the interests of its creditors, and hence on an improper basis.”<sup>128</sup>

This case involved a director being paid a debt owed to him by the company, but other cases suggest that even where there is payment to a non-associated party the liquidator can recover.<sup>129</sup> Thus, there is no basis for distinguishing between cases where directors benefited and where they did not benefit. In either case, where there is a debt paid off, the company experiences no loss yet courts have found for liquidators.

In *Northampton Borough Council v Anthony Michael Cardoza*<sup>130</sup> Newey J. considered, in the context of remedies, the decision in *HLC Environmental Projects* as well as mentioning *West Mercia*, and he offered some explanation for differences in the case law. Whether a claim for relief in relation to a preference should succeed depended on a number of things and especially whether the company was in liquidation. In both *HLC Environmental Projects* and *West Mercia* the companies were in liquidation and that presented a different situation to *Maroo* where the company was not.<sup>131</sup> The same can be said for the company in *Knight*<sup>132</sup> where it was not in liquidation and the action was initiated by a shareholder. Also, in *Berg Sons & Co Ltd v Adams*<sup>133</sup> while the proceedings were brought in a liquidation they were against former auditors of the company and did not involve the duty now referred to in s.172(3). It might be concluded, therefore, that the absence of loss is not an issue where the company has entered liquidation and a liquidator is making the claim. It might also be argued that the payment of a preference can mean that the company has in fact experienced a loss. This is explained in a recent decision, *Northampton Borough Council v Anthony Michael Cardoza*<sup>134</sup> another and later decision in the litigation considered by Newey J above. In this later case H.H. Judge Simon Barker Q.C. (sitting as a High Court judge) said, in relation to Newey J.’s judgment that he did not understand:

“Newey J to have meant that in all cases where the balance of assets net of liabilities remains unchanged by reversing a preference the company is unlikely to have suffered a loss. For example, the net assets figure may remain the same after restoration and a compensating adjustment to reinstate a liability to a director but the distribution of assets, notional or actual, to those entitled to receive them (creditors and contributories) may be very materially different. For example, restoration of cash to an otherwise illiquid but solvent (at net book values) balance sheet may have a significant effect on the company's ability to pay creditors and continue trading. Further, the sense in which the word 'loss' is used may include assets which ought to, but do not, form part of the trust estate because they have been misapplied, for example by disbursement without

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<sup>128</sup> [2018] CSOH 42 at [58]

<sup>129</sup> For instance, see *Re Cityspan Ltd* [2007] EWHC 751 (Ch); [2008] B.C.C. 60; *Re Cosy Seal Insulation Ltd (in administration)* [2016] EWHC 1255 (Ch).

<sup>130</sup> [2017] EWHC 2014 (Ch).

<sup>131</sup> [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [32].

<sup>132</sup> [1999] B.C.C. 819.

<sup>133</sup> [1992] B.C.C. 661.

<sup>134</sup> [2019] EWHC 26 (Ch) at [188].

authority. The remedy available to redress this 'loss' is restoration, which may be by compensation to restore the value of the assets to the trust estate.”

It is submitted that even if Judge Barker is wrong concerning the issue of loss, where there is a preference-type payment a restoration order can be made. That is, the court orders either the recipient creditor of the payment to repay the money to the company, or the director to pay a sum equivalent to the preference. In the former situation the company would again be indebted to the payee/creditor to the extent of the original debt.<sup>135</sup> .

The reason for permitting a restoration order could be two-fold. First, as the deputy judge in *HLC Environmental Projects* noted, a company is to be treated as in an equivalent position so far as its directors are concerned to that of a trust fund so far as its trustees are concerned,<sup>136</sup> and where there is misapplication of the funds of the company/trust there can be an order of restoration in relation to the funds. Directors are subject to the same constraints as trustees when dealing with the property of the company and so the analogy drawn by the deputy judge seems well-founded. In *Re Lands Allotment Co*<sup>137</sup> Kay L.J. said if directors deal with the funds of a company and they are funds which are under their control, and the dealing is beyond their powers, then they are treated as having committed a breach of trust. Chadwick L.J. in *J.J. Harrison (Properties) Ltd v Harrison*<sup>138</sup> made the same point.

The analogy with a trust fund can only be relevant to fiduciary duties. Van Zwieten has said that the analogy drawn in *HLC Environmental Projects* was inappropriate in cases involving only breaches of non-fiduciary duties.<sup>139</sup> This comment suggests that the commentator maintains that the duty referred to in s.172(3) is non-fiduciary, at least in cases where the director is not engaged in self-dealing.<sup>140</sup> In *HLC Environmental Projects* the deputy judge seemed to assume that the duty that is the subject of this paper is fiduciary in nature, and it is submitted he was right to do so. This can be demonstrated as follows. Section 212 of the Insolvency Act 1986, the provision through which claims under s.172(3) are usually brought, refers to a director being responsible for misfeasance if committing a “breach of any fiduciary or other duty.”<sup>141</sup> From this it might be argued, perhaps, that the duty to account for creditors’ interests falls under the words “other duty” distinguishing it from fiduciary duty. Yet, at the time of the decision in *West Mercia* s.212’s precursor, s.333 of the Companies Act 1948, did not include the words “breach of any fiduciary or other duty.” Rather, it referred only to a “breach of trust.”<sup>142</sup> The Court of Appeal was willing to accept in *West Mercia* that the breach of duty fell within s.333 and to make an order. This indicates that the Court regarded the breach of the duty to take creditors’ interests into account falling within the category of a “breach of trust” and breach of trust has been interpreted by the courts as including a breach

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<sup>135</sup> *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [147]; *Northampton Borough Council v Anthony Michael Cardoza* [2017] EWHC 2014 (Ch) at [32].

<sup>136</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [141].

<sup>137</sup> [1894] 1 Ch. 616 at 638.

<sup>138</sup> [2001] EWCA Civ 1467; [2002] B.C.C. 719 at [25].

<sup>139</sup> “Director Liability in Insolvency and Its Vicinity” (2018) 38 O.J.L.S. 382 at 402.

<sup>140</sup> See van Zwieten at 402.

<sup>141</sup> Section 212(1).

<sup>142</sup> Section 333(1).

of a fiduciary duty in a corporate context.<sup>143</sup> Furthermore, s.178(2) of the Act provides, in effect, that the duties in s.172 are fiduciary as the sub-section states that the duties in ss.171-177 are all enforceable, with the exception of the duty of care found in s.174, in the same way as any other fiduciary duty owed to the company. Of course, the duty under discussion is found in s.172(3).

If the duty is a fiduciary one it might be thought that restorative orders will only be made for breaches of duty which involved directors making payments based on self-interest. Yet, in *HLC Environmental Projects*,<sup>144</sup> and as mentioned earlier,<sup>145</sup> John Randall Q.C. rejected the notion that the Court of Appeal in *West Mercia* viewed it as crucial that the miscreant director was the one who received the payment. He said that if the Court of Appeal would not have found against the director unless there was benefit to the director, the Court would have made it clear.<sup>146</sup>

Nevertheless, it has been suggested<sup>147</sup> that the decision of the Supreme Court in *AIB Group (UK) plc v Redler*<sup>148</sup> presents a problem for the analysis that a restorative order may be granted. The reason is that in this case Lord Toulson, whose judgment was approved of by a majority of the Court, said that unless there is fraud which might give rise to other public policy considerations it would not be correct to impose a rule that provides redress for a beneficiary for loss which would have been suffered if the trustee had properly performed the required duties.<sup>149</sup> While the situation we are considering in this paper is different from that in *Redler* it might well be that the reasoning of Lord Toulson applies, and, therefore, unless the payment by a director involves fraud that has public effects there can be no relief ordered. As argued earlier,<sup>150</sup> undertaking an informal liquidation, by paying off selected creditors, might be seen as a fraud on the creditors, and thus this would bring the breach within Lord Toulson's fraud exception. Importantly, in *HLC Environmental Projects*<sup>151</sup> and *Re Micra Contracts Ltd*,<sup>152</sup> the courts were critical of the respondent director in choosing which creditors to pay and which to leave exposed to a risk of non-payment at a time when the director had to take into account the company's creditors.<sup>153</sup> Also, without mentioning the notion of an informal liquidation, in *West Mercia* Dillon L.J. said that the director involved had committed a fraud of the creditors of the company.<sup>154</sup> It is submitted that fraud on the creditors does have the potential to give rise to public policy considerations. First, fraud on creditors is not a narrow concept, and it can cover a number of transactions and those which are entered into in bad faith.<sup>155</sup> Secondly, it can be seen as an abuse of corporate power.<sup>156</sup>

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<sup>143</sup> *Re Lands Allotment Co* [1894] 1 Ch. 616; *J.J. Harrison (Properties) Ltd v Harrison* [2002] B.C.C. 719; *Gwembe Valley Development Co Ltd v Koshy* [2003] EWCA Civ 1048; [2004] 1 B.C.L.C. 131.

<sup>144</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337.

<sup>145</sup> See text accompanying fn 33.

<sup>146</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337 at [139]

<sup>147</sup> van Zwieteren, at 403.

<sup>148</sup> [2014] UKSC 58; [2015] A.C. 1503; [2014] 3 W.L.R. 1367.

<sup>149</sup> van Zwieteren, at 403 and referring to [62] of the case.

<sup>150</sup> See text accompanying fns 45-51.

<sup>151</sup> [2013] EWHC 2876 (Ch); [2014] B.C.C. 337, [106].

<sup>152</sup> [2016] B.C.C. 153 at [103]

<sup>153</sup> [2016] B.C.C. 153 at [106]

<sup>154</sup> (1988) 4 B.C.C. 30 at 33.

<sup>155</sup> See, *Sasea Finance Ltd v KPMG* [2002] B.C.C. 574 at 585.

<sup>156</sup> Armour in Armour and Bennett, *Vulnerable Transactions in Corporate Insolvency* at 282.

There have been comments made on a number of occasions about concern over the improper use of the power of companies and its effect on the public.<sup>157</sup> Thirdly, as mentioned earlier, the courts have stated that liquidations should not take place outside of the liquidation process,<sup>158</sup> and this is to ensure that there is an orderly distribution of the company's assets in an equitable manner. Fourthly, if directors are not protected to some degree it can have wide repercussions, not only for them but for society. These include: the reluctance of creditors to provide credit thereby making it difficult to carry on viable businesses; if creditors are not paid then it can have a knock-on effect in that they cannot pay their own creditors and so on down the credit line, and this can lead to insolvencies of other people and companies;<sup>159</sup> creditors pass on losses to their counter-parties and customers in the form of higher prices or interest rates.<sup>160</sup>

The second reason for permitting restoration is that s.212(3)(a), the provision which permits liquidators to bring misfeasance proceedings where a breach of duty has occurred, provides that if there is a breach of duty an order of restoration may be made as the court thinks fit. Dillon L.J. said in *West Mercia* that:

“The section in question [s.333 of the Companies Act 1948]...provides that the court may order the delinquent director to repay or restore the money, with interest at such rate as the court thinks fit, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication as the court thinks fit.”<sup>161</sup>

It is axiomatic that s.212 does not create or provide any separate claim. It is merely a procedural device enabling liquidators to get a speedier determination of a claim that they have independent of s.212 because they can get the matter before a judge more quickly.<sup>162</sup> Yet, the procedural tag must not detract from the fact that the provision in s.212(3) specifically gives a court power to order relief. Perhaps against the argument that restoration could be ordered under s.212, it might be posited that just as s.212 does not create an action that is not ordinarily available to a claimant it could not be said to be able to create a remedy that was not otherwise available to a claimant. Nevertheless, if a court is not entitled to make a restoration order under s.212(3)(a), wherever it deems it just, and whatever the action underlying the application, then there does not seem to be any purpose in including the paragraph in the section. The legislature could have merely omitted para.(3) and forced a claimant to rely on the remedies she would ordinarily have available if

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<sup>157</sup> For example, see Cable, “Trust: Why it Matters” (15<sup>th</sup> July 2013): <https://www.gov.uk/government/speeches/reform-conference-on-responsible-capitalism>; Work and Pensions Committee: “Carillion: Whole system of corporate accountability ‘built on sand’”: <https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/tpr-session-quote-17-19/>.

<sup>158</sup> *London Joint City & Midland Bank v Herbert Dickinson Ltd* [1922] W.N. 13 at 14.

<sup>159</sup> This is evident in the insolvencies of large companies like MG Rover and, more recently, Carillion.

<sup>160</sup> Zeigler, “The Fraud Exception to Discharge in Bankruptcy: A Reappraisal Note” (1986) 38 *Stanford Law Review* 891 at 905.

<sup>161</sup> (1988) B.C.C. 30 at 33. Another example of restoration under s.212 occurred in *Sandhu v Sidhu* [2009] EWHC 983 (Ch).

<sup>162</sup> *Cavendish-Bentinck v Fenn* (1887) 12 App. Cas. 652 at 669; *B. Johnson & Co (Builders) Ltd, Re* [1955] Ch. 634 at 647–648; *Cohen v Selby* [2001] 1 B.C.L.C. 176 at 183; *Re Eurocruit Europe Ltd* [2007] EWHC 1433 (Ch) at [11]; *Oldham v Kyrris* [2003] EWCA Civ 1506; [2004] B.C.C. 111.

relief identified in s.212 could not be ordered. Absent the paragraph, it has been argued above that a judge could still provide a remedy, but the inclusion of restoration in s.212 makes it plain that it can be ordered in any application before the court, if appropriate.<sup>163</sup>

A final point to note concerning the issue of no company loss is the fact that the case law that has criticised the recovery of preferences on the basis that there has been no loss to the company has not dealt with the comments of Street C.J. in *Kinsela v Russell Kinsela Pty Ltd*,<sup>164</sup> comments which have been approved of in a significant volume of cases, including by the Court of Appeal in *West Mercia* and very recently in *BTE 2014 LLC v Sequana SA*<sup>165</sup> as well as in the dicta of two Supreme Court judges in *Bilta (UK) Ltd (in liquidation) and others v Nazir and others (No 2)*.<sup>166</sup> Street C.J. said this:

“In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when the questions of the duty of directors arise...But where a company is insolvent the interests of the creditors intrude. They [the creditors] become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets. It is in a practical sense their assets and not the shareholders’ assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.”<sup>167</sup>

As has been previously noted elsewhere,<sup>168</sup> other cases have taken a similar position. In *Brady v Brady*<sup>169</sup> Nourse L.J. said, in obiter, that when a company is insolvent the interests of the company are in reality the interests of the existing creditors. In *Re Pantone 485 Ltd*<sup>170</sup> Richard Field Q.C. (sitting as a deputy judge of the High Court) said: “where the company is insolvent, the human equivalent of the company for the purposes of the directors’ fiduciary duties is the company’s creditors as a whole, i.e. its general creditors.”<sup>171</sup> Other cases refer to the interests of the company being those of the creditors during a period of insolvency or near insolvency.<sup>172</sup> If the interests of the company are equated to the interests of the creditors then it is possible to say that the company has experienced a loss.

## VI Conclusion

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<sup>163</sup> A court may always decline to make an order against a director if it decides that the directors should be excused pursuant to s.1157 of the Act: *Re Home and Colonial Insurance Co* [1930] Ch. 102.

<sup>164</sup> *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 A.C.L.R. 395.

<sup>165</sup> [2019] EWHC Civ 112.

<sup>166</sup> [2015] UKSC 23; [2016] A.C. 1.

<sup>167</sup> (1986) 10 A.C.L.R. 395 at 401.

<sup>168</sup> Keay, “Directors’ Duties and Creditors’ Interests” (2014) 130 L.Q.R. 443 at 467.

<sup>169</sup> (1987) 3 B.C.C. 535 at 552.

<sup>170</sup> [2002] 1 B.C.L.C. 266.

<sup>171</sup> *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266 at [73].

<sup>172</sup> *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch); [2010] B.C.C. 838 at [92]; *City of London Group plc v Lothbury Financial Services Ltd* [2012] EWHC 3148 (Ch) at [54].

An action against a director of an insolvent company under s.172(3) arguing that the director failed to consider the interests of the creditors at a time when the company was insolvent or near to it, is a valuable weapon in the litigation arsenal of a liquidator, and case law demonstrates that it has been employed effectively in a good number of liquidations. More specifically, liquidators may seek to bring proceedings against directors for a breach of the duty covered by s.172(3) when directors have made payments to one or more creditors at a time when the directors were obliged to take into account the interests of the creditors as a whole. There appears to be some uncertainty about whether liquidators can do this and so the paper asked whether it is correct that liquidators can challenge preference-type payments, and in the course of addressing this it has examined the problems that liquidators may encounter in taking such action.

The paper has found that liquidators are indeed entitled to claim for a breach of the duty against directors where they have caused their companies to make preference payments that fulfil the conditions of either s.239 or s.243 of the Insolvency Act 1986. It is not as clear-cut whether liquidators are entitled to claim a breach of duty where the preference payment, although causing prejudice to the creditors, does not fall within either s.239 or s.243. There is some older case law that suggests that liquidators cannot do so, but more recent case law supports a liquidator's action and it is contended that the latter view is sounder. This is because the effect of the payment is the same as in the case where the payment is a preference within the Insolvency Act, namely the general body of creditors is prejudiced by a preference payment in that the recipient of the preference gets more than the other creditors of the same class. It has been submitted in the paper that it is an important finding for liquidators that they are able to proceed against a director who makes a payment to a creditor in circumstances where the payment is not a preference within s.239 as it opens up potentially more opportunities to recover company funds. Hitherto, liquidators have been reluctant to take action against directors in case they are unable to establish all of the conditions of s.239. They may now consider taking actions against directors with more vigour and confidence.

In addition, the paper has found that simply establishing the conditions set out in s.239 or s.243 will not mean that the directors causing the payment of the preference will automatically lead to a finding of breach of duty. Liquidators will have to do more; they must demonstrate that the directors failed to consider the interests of creditors when making the payment.

The paper has demonstrated that a liquidator is only able to claim from the beneficiary of a preference which does not fall within the Insolvency Act and where he or she is not associated with the paying company or its director who authorises payment, if the creditor knew that the director making the payment was in breach of her duty under s.172(3) or the payments were not appropriately authorised.

While any action under s.172(3) is being brought on behalf of the company and, accordingly, compensatory relief can only be granted by a court if there is loss to the company, it has been submitted that there is nothing preventing a court from making a restoration order where a preference has been paid and, arguably there is no loss to the company. The respondent director can be ordered to repay to the company the sum that was paid to the

preferred creditor, and this is whether the preferred creditor was the director, an associated party or some independent person. It has also been argued that it is possible to see the payment of a preference can be regarded as leading to a loss for the paying company.

Thus, the conclusions of this paper mean that liquidators can challenge preference-like payments by directors to creditors under s.172(3) and it provides them with “an alternative means of putting unsecured creditors back in the distributional position they would otherwise have been had the payments not been made.”<sup>173</sup>

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<sup>173</sup> van Zwieten at 399.