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The Shifting of Directors' Duties in the Vicinity of Insolvency

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I Introduction

The role of directors in companies is incredibly important for many reasons. In order to discharge this role in most jurisdictions around the world either legislation or the company's own articles of association (by-laws) endows them with broad powers to manage the affairs of the company. This power inevitably means that obligations and responsibilities are placed on directors. Of great importance in this regard are duties that are imposed on directors, predominantly by statute, but alternatively in some jurisdictions, such as Hong Kong, by case law. In some jurisdictions, such as Australia, duties are laid down in both case law and legislation. Much discussion has been entered into across the world concerning the nature of the duties owed by directors and, particularly, in relation to whom those duties are owed. The duties are often said to be owed to the company. Legislation often provides that the duties are to be exercised in the best interests of the company. This can mean a number of things. It often will depend on how the courts decide what "company" means in the circumstances. Generally speaking the focus tends to be, in Anglo-American jurisdictions and even some civil law systems such as China, on the interests of the shareholders, while in some jurisdictions, such as Germany and the Netherlands, the interests of other stakeholders might come into play regularly or at least in certain specified circumstances.

The general approach, particularly in Anglo-American jurisdictions, is that when a company is solvent the shareholders' interests are primary as they have invested capital in the company and if the company is successful then they will benefit substantially, but if the company fails financially the shareholders will lose much, if not all, of their investment because all creditors will be paid before shareholders have any of their investment returned to them. But in the case where a company is in financial difficulty and might be within the vicinity of insolvency a change of approach might well apply. The vicinity of insolvency might be seen as an imprecise term. But usually it is regarded as a point of time that is often referred to as "the twilight zone" or "zone of insolvency," when the company is in financial distress and may well be moving from solvency towards and even into insolvency. It has been said that it is a period : "in which there is a deterioration of the company's financial stability to the extent that insolvency has become imminent."[1] In some jurisdictions there is a shift in the nature of the duties of directors that are owed when their

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[1] UNCITRAL Legislative Guide on Insolvency Law, "Directors' obligations in the period approaching insolvency" Working Group V, 43rd session, New York, 15-19 April 2013 at para 22, and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014)

company is in the vicinity of insolvency. I explore the theoretical reason behind this shift briefly later on.

Over the past 40 years we have seen a substantial jurisprudence develop in the UK and many other common law jurisdictions, such as Ireland, Australia, New Zealand and Singapore, in relation to the shifting of the duties of directors when their company is in insolvency or in the vicinity of insolvency.[2] That is, there is a shift in the duties of directors to the extent that they are under a duty to take account of the interests of the creditors of the company. In recent years Working Group V (Insolvency Law) of UNCITRAL has been studying the obligations of directors in the period approaching insolvency and the Working Group has sought to identify the options that are available when a company is in the vicinity of insolvency in order to inform policymakers as they seek to devise appropriate legal and regulatory frameworks.[3] The Group has referred to the common law developments which have involved the shifting of directors' duties and which are discussed in this paper.[4]

In light of the exploration by Working Group V (Insolvency Law) of UNCITRAL of the options available when a company is in the vicinity of insolvency, the paper considers the shifting of directors' duties in this period and its aim is primarily two-fold. First, to provide an analytical exposition of the position that exists in common law jurisdictions as far as the shifting of directors' duties is concerned. Second, to identify the main problems that exist with this position, and so if other jurisdictions, particularly those in Europe, do consider implementing this approach they are aware of the problems and issues that exist. In this regard there is a brief consideration of the approach across the European Union (EU), in very general terms prior to detailed discussion of issues that arise from the Anglo-Commonwealth jurisprudence that may provide the basis for some resistance against the possibility of an embracing of that approach in the EU.

I should emphasise that the paper does not seek to address all of the issues that relate to a company falling into insolvency or one that is in the vicinity of insolvency. The focus is on the issue of the shifting of the duties of the directors of the company.

II General Issues

2 The United States has also seen developments in this area. See, for instance, *Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp* (1991 Del Ch WL 277613; LEXIS 215; (1992) 17 *Delaware Journal of Corporate Law* 1099; *North American Catholic Educational Programming Foundation Inc v Gheewalla*, 930 A 2d 92 (Del, 2007); A. Dionee, "Living on the Edge : Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency" (2008) 13 *Stanford Journal of Law, Business and Finance* 188; S. Willett, "Gheewalla and the Directors' Dilemma" (2009) 64 *Business Lawyer* 1087; N. Rubin, "Duty to Creditors in Insolvency and the Zone of Insolvency : Delaware and the Alternatives" (2011) 7 *New York University Journal of Law and Business* 333.

3 The latest being, UNCITRAL Legislative Guide on Insolvency Law, "Directors' Obligations in the period approaching insolvency" Working Group V, 43rd session, New York, 15-19 April 2013 and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014)

4 It has not clearly endorsed the approach although there are comments in recommendations that suggest that the Working Group seem to think that it needs to be considered : at pp14-15.

There are various responses around the world to companies that are in the vicinity of insolvency or are actually insolvent. In a significant number of jurisdictions, particularly in Europe, directors must file insolvency proceedings within a certain period of time of their company becoming insolvent, or else they could be held liable personally in tort for losses sustained by their company and its creditors. Other states provide, as Germany does, that if the company becomes insolvent or over-indebted, the board may not make any payments.[5] The German public companies legislation also provides that :

> "If upon preparation of the annual balance sheet or an interim balance sheet it becomes apparent, or if in the exercise of proper judgment it must be assumed that the company has incurred a loss equal to one half of the share capital, the management board shall promptly call a shareholders' meeting and advise the meeting thereof."[6]

This provision is a response to art 19 of the EU's Second Company Law Directive.[7] The German approach is representative of the legislation found in the majority of Member States and put into effect as a result of the Second Directive. It merely provides that the directors must call a meeting of shareholders. This is regarded as the minimum requirement under the Second Directive. Other States' legislative response to art 19[8] demands more and requires the board to call a meeting and have the company decide, upon losing half of its subscribed share capital, whether to recapitalise or wind down the company's business and liquidate it.

In most common law jurisdictions there is no obligation on the directors to file proceedings if their company becomes insolvent. Many companies in the UK, for instance, are at any one time insolvent and they are not, per se, breaching any law. They might continue to fall further into insolvency or they might recover and become solvent again. The directors are not liable merely for running the affairs of an insolvent company. Some boards will effectively file insolvency proceedings by taking their companies into administration or liquidation, but they are not required to do so.

But what about when a company is not insolvent, but in the vicinity of insolvency? Again boards might not be liable, but they are not free to do whatever they like. In several jurisdictions there is legislation that provides that directors must have some regard for the position of creditors when the company is in the vicinity of insolvency. A classical example of this is s.214 of the UK's Insolvency Act 1986 which legislates against what it calls "wrongful trading."[9] In essence this provision states that if

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5 Stock Corporation Act (Aktiengesetz), art 92(2) . Previously the article in the legislation required the directors to file insolvency proceedings within three weeks.

6 Stock Corporation Act (Aktiengesetz), art 92(1) .

7 2012/30/EU, OJ 2012 L 315/74.

8 See, the Czech Republic, Estonia, France, Italy, Latvia, Lithuania, Portugal, Spain and Sweden.

9 This appellation is mentioned as a heading to the section but is not included in the actual wording of the section. It has been argued that it is an unfortunate heading as it implies that there is a need for blameworthy conduct before a director can be held liable and this is not the case : A. Keay, "Wrongful trading : problems and proposals" (2014) 65 *Northern Ireland Legal Quarterly* 63. There is a substantial amount of literature that deals with wrongful trading. For instance, see F Oditah, "Wrongful Trading" [1990] LMCLQ 205; T Cooke and A Hicks, "Wrongful Trading – Predicting

directors know or ought to conclude that there was no reasonable prospect of the company avoiding going into insolvent liquidation then unless they take every step to minimise the potential loss to creditors they will be personally liable to contribute to the company's losses if the company does end up in insolvent liquidation.

As far back as November 2002 the European Commission's High Level Group of Company Law experts regarded s.214 as a model for an obligation that should be imposed on directors prior to insolvency in Member States of the EU.[10] I must demur. While, in my view, there are several meritorious ideas underlying the wrongful trading concept, s.214 contains many pitfalls for a liquidator who is contemplating taking action against a director on this ground. If a s.214 type of obligation is to be applied in the EU or anywhere then I believe that the present s.214 needs to be reconstructed somewhat, as I have argued elsewhere.[11] Briefly, I have said that there are a number of problems with the wrongful trading provision or the way that it has been applied. First, it is not easy for a liquidator to determine the point from which directors might be regarded as liable, because they failed to take every step to minimise the potential loss to creditors. Second, the legislation requires directors to gaze into the future and determine if their company is heading for insolvent liquidation and that might well engender uncertainty. Third, some UK judges have appeared to look for some clear wrongdoing on the part of the directors,[12] before holding them liable and yet the provision does not seem to require any need to establish blameworthiness on the part of the directors. Allied to this is the fact that in the UK the courts have tended to be generous to directors when hearing claims against them.[13] If wrongful trading is not to be reformed, there may well be a need for something like a requirement of a shift in directors' duties when a company is in the vicinity of insolvency to supplement wrongful trading.

What has developed in many common law countries is the employment of a duty that shifts the nature of the obligations of the directors to the point where they have to take

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Insolvency" [1993] JBL 338; H Boschma and L Lennarts, "Wrongful Trading in a Comparative Perspective" in J Wouters and H Schneider (eds), *Current Issues of Cross-Border Establishment of Companies in the European Union* (Maklu, Antwerp, 1995); P Godfrey and S Nield, "The wrongful trading provisions – all bark and no bite" (1995) 11 IL & P 139; A Walters, "Enforcing Wrongful Trading – Substantive Problems and Practical Incentives" in BAK Rider (ed), *The Corporate Dimension* (Jordans, Bristol, 1998); C. Cook, "Wrongful Trading – Is it a Real Threat to Directors or a Paper Tiger" [1999] Insolv L 99; R Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions : Redistribution, Perverse Incentives and the Creditors' Bargain" (2000) 59 CLJ 335; T Bachner, "Wrongful Trading Before the High Court" [2004] EBOR 195; A Keay, "Wrongful Trading and the Liability of Company Directors : A Theoretical Perspective" (2005) 25 *Legal Studies* 431; A Keay and M Murray, "Making Company Directors Liable : A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) 14 *International Insolvency Review* 27; A Keay, *Company Directors' Responsibilities to Creditors* (Routledge, Abingdon, 2007), 81-110; R Goode, *Principles of Corporate Insolvency Law* (4th, Sweet and Maxwell, London, 2011), 663-679; R Williams, "What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?" (2015) 78 MLR 55.

10 See the discussion in T Bachner, "Wrongful Trading – A New European Model for Creditor Protection" (2004) 5 EBOR 293.

11 A Keay, "Wrongful trading : problems and proposals" (2014) 65 *Northern Ireland Legal Quarterly* 63.

12 For instance, *Re Continental Assurance Co of London plc* [2001] BPIR 733; *Re Cubelock Ltd* [2001] BCC 523.

13 This is well demonstrated by the decision in *Re Continental Assurance Co of London plc* [2001] BPIR 733.

into account the interests of their companies' creditors when their company is in financial distress. It is this obligation to which the paper now turns.

III The Position in Relation to Shifting Duties

At the outset it should be stated that in the common law jurisdictions where there is a shift in the nature of the duty of directors from being shareholder-oriented to being more creditor-oriented in the situation where their company is in the vicinity of insolvency, there is also a shift if the company is actually insolvent, usually either on a cash flow or balance sheet basis. For a number of reasons this approach to the duties of directors can supplement the role of wrongful trading[14] and actually make up for weaknesses in inherent in the wrongful trading ground.[15]

The first matter to consider, if somewhat briefly, is the theory that underpins the shift in duties.[16] The shift in duty is a form of creditor protection, inhibiting companies externalising the cost of their debts at the time of financial distress. The reason for the duty is that if the company is in the vicinity of solvency or embarking on a venture which it cannot sustain without relying totally on creditor funds, "the interests of the company are in reality the interests of existing creditors alone."[17] The shareholders are the owners of the residual value of the firm (the residual owners being those whose wealth directly rises or falls with changes in the value of the company[18]), but when a company is close to insolvency the shareholders interest is of marginal value and the directors are effectively playing with the creditors' money,[19] as any further losses could propel the company into insolvency meaning that the creditors will not receive full payment (save perhaps the secured creditors). So, the creditors may be seen as the major stakeholders in the company.[20] The result is that the directors have an obligation not to sacrifice creditor interests.[21]

According to the views of financial economists, directors could be expected, when their companies are in difficulty, to embrace actions which involve more risk.[22] The

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[14] As the duty can be triggered before the directors are obliged to adhere to s.214 of the Insolvency Act.

[15] For instance, see A Keay, *Company Directors' Responsibilities to Creditors,* (Abingdon, Routledge, 2007) at 105-107.

[16] For discussion of the theory, see, for example, A Keay, "Directors' Duties to Creditors : Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 *Modern Law Review* 665.

[17] *Brady v Brady* (1988) 3 BCC 535 at 552

[18] D Baird, 'The initiation problem in bankruptcy' (1991) 11 *International Review of Law and Economics* 223 at 228-229; S Gilson, and M Vetsuypens, 'Credit Control in Financially Distressed Firms : Empirical Evidence' (1994) 72 *Washington University Law Quarterly* 1005 at 1006. This seems to be what was being said in *Brady v Brady* (1988) 3 BCC 535.

[19] R Millner, 'What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?' (2000) 9 *Journal of Bankruptcy Law and Practice* 201 at 207; R Hartman, 'Situation Specific Fiduciary Duties for Corporate Directors : Enforceable Obligations or Toothless Ideals' (1993) 50 *Washington and Lee Law Review* 1761 at 1771; R Lipson, 'Directors' Duties to Creditors : Volition, Cognition, Exit and the Financially Distressed Corporation' (2003) 50 *University of California at Los Angeles Law Review* 1189 at 1212.

[20] *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215 at 221.

[21] *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215 at 221

[22] See *Credit Lyonnais Bank Nederland N.V. v Pathe Communications Corp.* 1991 Del Ch WL 277613; LEXIS 215; (1992) 17 *Delaware Journal of Corporate Law* 1099 (Delaware Chancery Court). Also, see C C Nicolls, 'Liability of Corporate Officers and Directors to Third Parties' (2001) 35

shareholders might even press the directors to take more risk because if the risk works out then the shareholders could benefit significantly. Of course, if the venture is unsuccessful the shareholders, because of the concept of limited liability, will not lose any more than they would if the company took no action. If the directors engage in excessive risk-taking,[23] then the creditors will be the ones to lose out if the risk does not bear fruit. Professor Robert Scott puts it this way:

> "As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehaviour. But once the business environment deteriorates, the [company's manager] is increasingly influenced by a "high-roller" strategy. The poorer the prospects for a profitable conclusion to the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct."[24]

There is empirical evidence to support the fact that this tends to occur,[25] and it has become axiomatic that this risk-taking will take place,[26] particularly where the directors are also the "owners"[27] in the context of closely-held companies, that is those companies with few shareholders and where the shareholders are managing the company.

A second reason for the duty is that the level of risk upon which credit was calculated and extended by creditors has changed, and the duty compensates the creditor accordingly. The duty provides "the greatest protection at the time of the greatest risk, and, by changing what the board can reasonably justify as being in the corporate interest"[28] prevents misuse of the corporate power to incur liabilities. So, the issue in

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Canadian Business Law Journal 1 at 35; R Hartman, 'Situation Specific Fiduciary Duties for Corporate Directors : Enforceable Obligations or Toothless Ideals' (1993) 50 *Washington and Lee Law Review* 1761 at 1771; R de R Barondes, 'Fiduciary Duties of Officers and Directors of Distressed Corporations' (1998) 7 *George Mason Law Review* 45 at 46; J Armour, 'The Law and Economics of Corporate Insolvency : A Review' (2001) ESRC Centre for Business Research, University of Cambridge, Working Paper No 197, at 1.

23 See, F Easterbrook, and D Fischel, *The Economic Structure of Company Law*, (Harvard University Press : Cambridge, Mass, 1991), at 60; V Jelisavcic, 'A Safe Harbour Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the 'Vicinity of Insolvency' [1992] *Journal of Corporation Law* 145 at 148.

24 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597 at 624.

25 R Daniels, 'Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance' in J Ziegel, (ed), *Current Developments in International and Comparative Corporate Insolvency Law*, Oxford : Clarendon Press, 1994), at 549. However, R de Barondes, 'Fiduciary Duties of Officers and Directors of Distressed Corporations' (1998) 7 *George Mason Law Review* 45 at 62 challenges this view.

26 R Adler, 'A Re-Examination of Near-Bankruptcy Investment Incentives' (1995) 62 *University of Chicago Law Review* 575 at 590-598; R de Barondes, 'Fiduciary Duties of Officers and Directors of Distressed Corporations' (1998) 7 *George Mason Law Review* 45 at 46, 49.

27 R. Mokal, 'An Agency Cost Analysis of the Wrongful Trading Provisions : Redistribution, Perverse Incentives and the Creditors' Bargain' (2000) 59 CLJ 335 at 353-354.

28 R. Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] JBL 1 at 15.

this area is not one of mismanagement but one of creditors being exposed to risks that they did not agree to accept.[29]

The view might be expressed that if there is a shift in the duty before a company actually becomes insolvent the company's creditors might in fact sustain fewer losses or the company might even be turned around.

It should be said the shift in duties does not provide creditors with a right to take legal proceedings against the directors whom the former believe are in breach under the shift. Creditors have no standing to sue. The duties of the directors remain owed to the company and thus only the company can take action against defaulting directors. The only way that the company's action is likely to be enforced is if shareholders brought derivative proceedings on behalf of the company against the directors (a very unlikely occurrence) or an officeholder did so when appointed as an administrator or liquidator. In the latter case the administrator or liquidator would be bringing proceedings on behalf of the company.

The duty of directors to take into account the interests of creditors owes its genesis to several decisions delivered in Australasia, although in the United States some state courts had found that directors were liable to act in favour of creditors at certain times pursuant to the trust fund doctrine.[30] The starting point for any consideration of a shift in the duties of directors in this context is the judgment of the High Court of Australia in *Walker v Wimborne.*[31] In that case a liquidator had brought misfeasance proceedings against several directors of the company being liquidated, Asiatic Electric Co Pty Ltd ('Asiatic'). The claim was based on the fact that the directors had moved funds from Asiatic to other companies in which they held directorships. The relevant companies, including Asiatic, were treated by the directors as a group. The directors were accustomed to moving funds between companies and when this was done no security was usually taken, and no interest charged or paid. At the time of the movement of funds that was the subject of the action, Asiatic was insolvent. Asiatic later entered liquidation. In his leading judgment, Mason J said:

> In this respect it should be emphasised that the directors of a company in discharging their duty to the company must take into account the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.[32]

His Honour went on to say that the transactions attacked by the liquidator were entered into pursuant to a course of conduct that involved a total disregard for the interests of Asiatic and its creditors.[33] The judge said that for there to be a

29 D. Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323 at 354.

30 For example, see *New York Credit Men's Adjustment Bureau Inc v Weiss* (1953) 110 NE 2d 397. For a discussion of the doctrine, see, for example, A. Schaffer, "Corporate fiduciary – insolvent : the fiduciary relationship your corporate law professor (should have) warned you about" (2000) 8 *American Bankruptcy Institute Law Review* 479 at 543-550.

31 (1976) 137 CLR 1; (1976) 3 ACLR 529

32 (1976) 137 CLR 1 at 6-7; (1976) 3 ACLR 529 at 531.

33 (1976) 137 CLR 1 at 7; (1976) 3 ACLR 529 at 532.

misfeasance there had to be a breach of duty, and in his view the actions of the directors constituted a breach of duty. His Honour was clearly accepting that directors had a positive obligation to creditors. The comments of Mason J were obiter, but it might be argued that what he said "has taken on an authoritative status over the years."[34]

The decision was followed in several Australian cases, and perhaps most notably in *Kinsela v Russell Kinsela Pty Ltd*[35] which became a very influential decision, as far as the UK, Ireland and most Commonwealth jurisdictions are concerned. This was a decision given by the Court of Appeal of New South Wales. In that case the liquidator of a company ("RK"), which carried on business as a funeral director, brought proceedings to have a lease over premises granted by RK to directors of the company, set aside. The lease had been granted three months before the commencement of winding up, and at a time when the company's financial position was precarious. The company had sustained a significant loss during the previous year, had suffered less severe losses for several years and the accounts some six months before the lease was entered into showed that the company's liabilities exceeded its assets by nearly A$200,000. Also of importance, was the fact that the company had committed itself to performing services in relation to pre-paid funerals. The lease involved the directors being given a term of three years at a below market rental, there was no escalator clause to cover inflation and the directors were entitled, during the life of the lease, to purchase part of the premises for a sum which was well below true value. The Court found that the intention of the directors was to put the assets of RK beyond the reach of its creditors, and to preserve what had been a family business for many years.[36] In delivering the leading judgment (with which the other members of the Court concurred), Street CJ said that when a company is insolvent, the creditors' interests intrude.[37]

It was not for some years after *Walker v Wimborne* was decided that the approach it took was followed in England. There were some statements made in the occasional case that indicated that the judges might favour this approach, but no direct application of the principle. In *Lonrho Ltd v Shell Petroleum Co. Ltd*[38] Lord Diplock said, without any further elaboration, that the best interests of the company are not exclusively those of the shareholders, 'but may include those of its creditors'(at 634). Subsequently in *Re Horsley & Weight Ltd*[39] Templeman LJ said that :

> "If the company had been doubtfully insolvent at the date of the grant [of the pension] to the knowledge of the directors, the grant would have been both a misfeasance and a fraud on the creditors for which the directors would remain liable."[40]

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34 J. McConvill, ' Directors' Duties to Creditors in Australian After Spies v The Queen' (2002) 20 *Company and Securities Law Journal* 4 at 12 and referring to R. Tomasic, J. Jackson, and R. Woellner, *Corporations Law : Principles, Policy and Process*, Sydney : Butterworths, 1996, at 413-418.

35 (1986) 4 ACLC 215; (1986) 10 ACLR 395.

36 (1986) 4 ACLC 215 at 219; (1986) 10 ACLR 395 at 399.

37 (1986) 4 ACLC 215 at 221; (1986) 10 ACLR 395 at 401

38 [1980] 1 WLR 627.

39 [1982] 1 Ch 442.

40 [1982] 1 Ch 442 at 455.

It was in *Liquidator of West Mercia Safetwear Ltd v Dodd*[41] that the English courts approved overtly of the approach taken in Australia. This case was before the English Court of Appeal and it has probably become the leading case in England on the issue under discussion.[42] In this case, 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 it also had a charge over its book debts. One debt owed to X was £30,000, and this was owed by Y. 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 liquidation of Y, the liquidator sought from the bank repayment to Y of the £4,000. The bank refused and so 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. At first instance, in the county court, the liquidator failed. He then appealed to the Court of Appeal. Dillon LJ, who gave the leading judgment with which the other members of the Court (Croom-Johnson LJ and Caulfield J) concurred, found that the payment constituted a fraudulent preference (under the Bankruptcy Act 1914). As far as the claim that there had been a breach of duty, his Lordship approved of what Street CJ said in *Kinsela v Russell Kinsela Pty Ltd,* particularly in relation to the directors having a duty to consider creditor interests when a company is in financial difficulty, and came to the view that there was a breach of duty on the part of D.

Shortly before *Kinsela v Russell Kinsela Pty Ltd* was decided the New Zealand Court of Appeal in *Nicholson v Permakraft (NZ) Ltd,*[43] a case where the company was said to be nearing insolvency at the time when directors took the action that was the subject of the claim against them,[44] accepted the fact that in certain circumstances the directors have a duty to take into account the interests of the creditors of their company. So this case indicated that there might be a duty shift when a company was not insolvent but in the vicinity of it. Such a view has been accepted and applied in many decisions since, particularly in the UK[45] and Australia,[46] where courts have noted that directors do have a shift in their duties when their company is in the vicinity of insolvency.

The UK, which is virtually alone in doing this, has now codified the shift in obligation placed on directors at common law when the company is in the vicinity of insolvency or insolvent. We begin with s.172(1) of the Companies Act 2006, a provision that has caused much debate and uncertainty.[47] It provides that directors must act in the way

[41] (1988) 4 BCC 30.

[42] Professor Paul Davies has said that the case provides the clearest recognition of the duty in English law : *Gower's Principles of Company Law*, 6th ed, London, Sweet and Maxwell, 1997, at 603.

[43] (1985) 3 ACLC 453.

[44] (1985) 3 A.C.L.C. 453 at 459.

[45] *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 BCLC 218; *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885; *Eastford Limited v Gillespie, Airdrie North Limited* [2010] CSOH 132; *Re Idessa (UK) Ltd* (sub nom *Burke v Morrison*) [2011] EWHC 804 (Ch); [2012] B.C.C. 315.

[46] For example, *Re New World Alliance* (1994) 51 F.C.R. 425 at 444-445; (1994) 122 A.L.R. 531; *Linton v Telnet Pty Ltd* (1999) 30 A.C.S.R. 465; *Spies v The Queen* [2000] HCA 43; 201 C.L.R. 603; *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239.

[47] As far as the academic commentary is concerned, see, for instance, A. Keay, "Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective" [2006] L.M.C.L.Q. 335; S. Kiarie, "At Crossroads: Shareholder Value, Stakeholder Value and

that they consider, "in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole" and then it provides that directors are to have regard for certain factors such as the likely consequences of their decisions in the long term. The courts have taken the view that the provision is the modern way of saying that the directors are to act in good faith in the best interests of their companies,[48] an obligation that is imposed on in many countries,[49] and, therefore, the courts have applied the law that was extant prior to s.172(1)'s introduction and that related to the duty to act bona fide in the best interests of companies. This paper is more concerned with s.172(3) that provides that the duty set out in s.172(1) is subject to any enactment or rule of law requiring directors**,** in certain circumstances**,** to consider or act in the interests of creditors. Thus, in certain cases the obligation in s.172(3) trumps the duty in s.172(1). In referring to "any rule of law," s.172(3) constitutes, inter alia, statutory recognition of the principle that has been recognised in, and developed by, the cases discussed above. And the cases that have been heard since the advent of s.172(3) have clearly accepted this by referring regularly to, and relying upon, the cases that were decided prior to the Act's enactment.

The shift in duty approach has been applied in many other cases in England,[50] Ireland,[51] Australia,[52] New Zealand,[53] and also in various other jurisdictions.[54]

IV The European Approach

Enlightened Shareholder Value: Which Road Should the United Kingdom Take?" (2006) 17 I.C.C.L.R. 329; D. Fisher "The Enlightened Shareholder – Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 Make Directors Consider the Impact of Their Decisions on Third Parties?" (2009) 20 I.C.C.C.L.R. 10; A. Alcock, "An Accidental Change to Directors' Duties?" (2009) 30 *Company Lawyer* 36; A. Keay, *Enlightened Shareholder Value Principle and Corporate Governance* (Abingdon, Routledge, 2013), Chapter 4.

48 For example, see *Cobden Investments Ltd v RWM Langport Ltd (sub nom : Re Southern Counties Fresh Foods Ltd)* [2008] EWHC 2810 (Ch) at [52]. Also, see *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm) at [260].

49 For instance, Australia (s.181 of the Corporations Act 2001), the Netherlands (art 2: 129 sub 5 of the Dutch Civil Code).

50 For example, *Facia Footwear Ltd (in administration) v Hinchliffe* ([1998] 1 BCLC 218; *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885; *Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch); [2004] EWHC 42 (Ch); [2005] B.C.C. 783; *Re Cityspan Ltd* [2007] EWHC 751 (Ch); [2008] B.C.C. 60; *Re Capitol Films Ltd (in administration)* [2010] EWHC 2240 (Ch); [2011] 2 B.C.L.C. 359; *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch); [2010] B.C.C. 838; *City of London Group plc v Lothbury Financial Services Ltd* [2012] EWHC 3148 (Ch); *Roberts v Frohlich* [2011] EWHC 257 (Ch); [2012] B.C.C. 407; [2011] 2 B.C.L.C. 625; *Re Idessa (UK) Ltd* (sub nom *Burke v Morrison*) [2011] EWHC 804 (Ch); [2012] B.C.C. 315; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch).

51 For example, *Re Frederick Inns Ltd* [1991] I.L.R.M. 582 and affirmed at [1994] ILRM 387; *Jones v Gunn* [1997] 3 IR 1; [1997] 2 ILRM 245.

52 For example, *Grove v Flavel* (1986) 4 A.C.L.C. 654; *Jeffree v NCSC* (1989) 7 A.C.L.C. 556; *Galladin Pty Ltd v Aimnorth Pty Ltd (in liq)* (1993) 11 A.C.S.R. 23; *Linton v Telnet Pty Ltd* (1999) 30 A.C.S.R. 465; *Spies v The Queen* [2000] HCA 43; 201 C.L.R. 603; *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239.

53 For example, *Hilton International Ltd (in liq) v Hilton* [1989] N.Z.L.R. 442.

54 For example, Ireland. See, *Byrne v Shelbourne Football Club Ltd* (Unreported, 8 February 1984, High Court and noted in H. Linnane, 'Directors' duties to creditors : the adoption of Kinsela v Russell Kinsela Pty Ltd in Irish law' (1995) 16 Co Law 319; *Re Frederick Inns Ltd* ([1991] ILRM 582 (Irish HC) and affirmed at [1994] ILRM 387 (Irish SC)); *Jones v Gunn* ([1997] 3 IR 1; [1997] 2 ILRM 245.

What jurisdictions across Europe require of directors when their companies are in the vicinity of insolvency differs quite substantially, as we have seen already to some degree, so is not possible to discuss all of the jurisdictions of Europe in this paper, but I now consider some of the approaches that have been taken.

In most jurisdictions in the EU the existence of a vicinity of insolvency situation does not, unlike the position already outlined and taken in many common law jurisdictions, lead to any marked change in the general duties of directors. The only jurisdictions in which a shift is seen are Cyprus, Denmark, Estonia, Hungary, Ireland, Latvia, Malta and the UK.[55] Only the UK and Ireland definitely would take the approach discussed in this article, and this is probably because they place such an emphasis on duties being shareholder-regarding when their companies are solvent. Denmark, for instance, addresses the vicinity of insolvency issue by providing that directors must exercise particular care when this situation exists. But the directors owe duties to all those who have a claim on the company at all times and this would include creditors,[56] so it is questionable whether there is in fact a shift. In Hungary the shift in duties involves prioritising the interests of creditors, and the directors might be held liable for a form of wrongful trading if they do not do so.[57] Where jurisdictions place less emphasis on shareholders, and more on a range of stakeholders, if a company is in the vicinity of insolvency it has been suggested that it might be left to the courts to engage in balancing the interests of stakeholders and taking into account the company's financial position.[58]

So in Member States where a directors' duty does not shift on the advent of the vicinity of insolvency, are directors free to do whatever they like provided that they are adhering to their established duties? The answer in relation to many of the Member States of the EU is "no." Several of these latter jurisdictions provide that directors can be held liable for a form of wrongful trading, that is, continuing to operate without mitigating their actions to minimise losses for creditors. As mentioned earlier, in the UK directors are required to take every step to minimise the potential loss to creditors the director is liable for wrongful trading if at some time prior to the commencement of winding up he or she knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation.[59] In other Member States while company directors are not subject to specific company law or insolvency law restrictions, they can be held liable in tort by creditors of the company. For instance, in the Netherlands directors might be subject to tortious actions by a creditor with whom they entered into a contract on the

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55 C. Garner-Beuerle, P. Paech and E. Schuster, "Study on Directors' Duties and Liability" April 2013, London, LSE, and prepared for the EC, at pp211-212 and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014).

56 C. Garner-Beuerle, P. Paech and E. Schuster, "Study on Directors' Duties and Liability" April 2013, London, LSE, and prepared for the EC, at pp288-289 and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014).

57 C. Garner-Beuerle, P. Paech and E. Schuster, "Study on Directors' Duties and Liability" April 2013, London, LSE, and prepared for the EC, at p327 and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014).

58 C. Gerner-Beuerle and E. Schuster, "The Evolving Structure of Directors' Duties in Europe" (2014) 15 EBOR 191 at 226.

59 Insolvency Act 1986, s.214.

company's behalf when the directors knew or should have known that the company would neither be able to meet its obligations to the creditor nor would there be sufficient assets to discharge the obligation to the creditor.[60]

V The Two Big Issues in the Common Law approach

There are two matters that need to be broached when it comes to consideration of the shift in duties provided for in the common law cases. First, when is the shift triggered? At what point does a director begin to be subject to the obligation to take into account the interests of the creditors? Second, how are the directors to conduct themselves when they are subject to this shift in duties? Are they to concern themselves solely with the interests of creditors or both the shareholders and creditors? If so, how do they do this? All of these questions are easy to pose, but far from easy to resolve.

A.When Does the Shift Occur?

As already mentioned all jurisdictions that have embraced a shift of duties approach have indicated that the shift definitely occurs when a company is insolvent. But the case law undoubtedly holds that the shift might occur before the advent of insolvency. It is important for directors to know at what that point there is a shift as it might well mean that they will need to change the way that they are managing the company. In the UK, for instance, because of s.172(3) of the Companies Act 2006, directors are no longer subject to the demand of s.172(1) requiring them to promote the success of the company for the benefit of the shareholders.

We now explore at what point it has been identified that the shift occurs. I should say at the outset that the courts have not explained what this state would actually encompass. They have been generally content to say that whether the obligation will arise or not is dependent on the facts.[61]

My view is that if directors are unsure whether circumstances dictate that they are to have a shift in the focus of their duties, it is best if they assume that they are subject to a shift and they should take into account creditors' interests. The reason for saying this is while this could, conceivably, precipitate the institution of a derivative action from shareholders, on the basis that the directors are in breach of s.172(1) in the UK or the duty that applies elsewhere, namely acting in the best interests of the company and where "the company" means the shareholders as a whole, this might well be unlikely, for a number of reasons. Primarily, before being able to bring or continue a derivative action shareholders will need, in many jurisdictions, to obtain the permission or leave of the court, and this process might deter a shareholder from taking action, particularly given the fact that permission is far from certain and they

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[60] The relevant rule in the Netherlands is called the "Beklamel-rule" and named after the case that decided that directors could be liable on the basis discussed in the article : C. Garner-Beuerle, P. Paech and E. Schuster, "Study on Directors' Duties and Liability" April 2013, London, LSE, and prepared for the EC, at p351 and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014).

[61] For example, see *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215 at 223; (1986) 10 A.C.L.R. 395 at 404; *Linton v Telnet Pty Ltd* [1999[NSWCA 33; (1999) 30 A.C.S.R. 465; *HLC Environmental Projects Ltd, Re* [2013] EWHC 2876 (Ch) at [89].

might well end up having to pay the (substantial) costs of the hearing.[62] Also, the legislation or case law of a jurisdiction might permit directors to consider other interests, including those of the creditors, even if the company is not in the vicinity of insolvency. For instance, in the UK s.172(1) requires directors to have regard to several factors set out in s.172(1)(a)-(f), such as the interests of the employees, and the provision clearly states that the factors in paragraphs (a)-(f) are not to be seen as exhaustive of the directors' consideration. The legislation seems to allow directors to have regard to other factors and this could include having consideration for creditors' interests (provided that it involves promoting the success of the company for the ultimate benefit of the members) and it might be thought to be prudent and proper that directors especially take creditors' interests into consideration when there are some doubts over the financial position and future of the company.

Clearly the mainstream of authority suggests that the duty does not arise where a company is clearly solvent. This point was made patent in the English Court of Appeal in *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd*[63] where Dillon LJ said that provided that a company is solvent the shareholders are in substance the company, and the directors, therefore, do not owe duties to creditors, or, arguably any other constituency of the company.[64] In Australia, the New South Wales Court of Appeal in *Equiticorp Finance Ltd (in liq) v BNZ*[65] also indicated that where there was no question about the solvency of a company, there was no need to consider the idea of a duty to creditors'[66] and more recent cases have taken the same view.[67]

The cases have variously described the circumstances when directors can be subject to the obligation. These circumstances are as follows. First, when their company is nearing,[68] approaching,[69] on the borderline of,[70] or on the verge of,[71] insolvency. Second, where the company is of doubtful solvency.[72] Third, where the company is subject to a risk of insolvency occurring.[73] Fourth, where to the knowledge of the

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62 See A. Keay and J. Loughrey, "An assessment of the present state of statutory derivative proceedings" in Loughrey (ed), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis* (Cheltenham, Edward Elgar, 2013), Chapter 7.

63 [1983] Ch 258.

64 The judge amplified his views in his judgment in *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30).

65 (1993) 11 ACLC 952.

66 (1993) 11 ACLC 952 at 1016

67 For instance, see *Re Pantone 485 Ltd* [2002] 1 BCLC 266 at 285.

68 *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453 at 459; *Re New World Alliance* (1994) 51 F.C.R. 425 at 444-445; (1994) 122 A.L.R. 531; *The Liquidator of Wendy Fair (Heritage) Ltd v Hobday* [2006] EWHC 5803 at [66].

69 *Geneva Finance Ltd v Resource and Industry Ltd* (2002) 20 A.C.L.C. 1427.

70 *Eastford Limited v Gillespie, Airdrie North Limited* [2010] CSOH 132 at [22].

71 *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885 at [74].

72 *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453 at 459; *Brady v Brady* (1988) 3 B.C.C. 535 at 552*; Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885 at [74]. Also, see the comments of Templeman L.J. in *Re Horsley and Weight Ltd* [1982] 1 Ch. 442 at 455.

73 For example, see *Grove v Flavel* (1986) 11 A.C.L.R. 161 at 170; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215 at 223; (1986) 10 A.C.L.R. 395 at 404 (agreeing with Cooke J in *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453); *Winkworth v Edward Baron Development Ltd* [1986] 1 W.L.R. 1512; *Hilton International Ltd (in liq) v Hilton* [1989] N.Z.L.R. 442.

directors there is a real and not a remote risk of insolvency and creditors would be prejudiced by the action considered.[74] Finally, there are cases where there is no reference to insolvency at all and the courts have been content merely to say that the company must be in a dangerous financial position,[75] a parlous financial state,[76] financially unstable,[77] or in financial difficulties (to the extent that the creditors are at risk) and where the state of affairs would endanger creditors' interests.[78] The descriptions of the state of the company in the last category are probably close to the company being of doubtful solvency or being subject to a risk of insolvency, and clearly there are overlaps between the descriptions. Overall though, all of these descriptions envisage a company being in the vicinity of insolvency.

It would seem that the nearer a company gets to actually being insolvent the more obvious it is that the duty will be triggered. But the circumstances identified by the courts do lack precision. This might be because the statements made by the courts are not intended to be taken too strictly and they all mean much the same thing. In the Australian case of *Kinsela v Russell Kinsela Pty Ltd* Street CJ said: "I hesitate to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors."[79] In a similar way in *Re HLC Environmental Projects Ltd (in liquidation)*,[80] Mr John Randall QC (sitting as a Deputy Judge of the High Court of England and Wales) said, after he had referred to the various ways the courts had previously identified the trigger for the advent of the duty, that he did "not detect any difference in principle behind these varying verbal formulations."[81] Thus it might be said that they all add up to the vicinity of insolvency, which is itself a rather vague term.

The lack of precision as to when the shift in duty is to occur might manifest the fact that the law cannot be too prescriptive here. There is a need for a balance, involving consideration for the fact that directors must be permitted to manage companies in a commercial manner, but the law must ensure that it does not permit directors to disregard the position of the creditors when a company is in the vicinity of insolvency. Limited liability is a privilege and courts have often been aware of the fact that the concept can be abused[82] and work to the disadvantage of creditors.

B. How are Directors to Act When the Duties Have Shifted?

1. Generally

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74 *Kalis Enterprises Pty Ltd v Baloglow* [2007] NSWCA 191 at [162]; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch) at [89].

75 *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 B.C.L.C. 218 at 228.

76 *Williams v Farrow* [2008] EWHC 3663 (Ch) at [21].

77 *Linton v Telnet Pty Ltd* [1999] NSWCA 33; (1999) 30 A.C.S.R. 465.

78 *Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch); [2004] EWHC (Ch) 42; [2005] B.C.C. 783 at [70]; *Re Idessa (UK) Ltd* (sub nom *Burke v Morrison*) [2011] EWHC 804 (Ch); [2012] B.C.C. 315 at [55].

79 (1986) 4 A.C.L.C. 215 at 223; (1986) 10 A.C.L.R. 395 at 404.

80 [2013] EWHC 2876 (Ch).

81 [2013] EWHC 2876 (Ch) at [89].

82 UNCITRAL Legislative Guide on Insolvency Law, "Directors' Obligations in the period approaching insolvency" Working Group V, 43rd session, New York, 15-19 April 2013, at para 9, and accessible at : http://daccess-dds-ny.un.org/doc/UNDOC/LTD/V13/807/89/PDF/V1380789.pdf?OpenElement (accessed, 1 December 2014).

It must not be forgotten that this paper considers actions in the vicinity of insolvency, and not insolvency per se. I say this because there might be good arguments for saying that a director's actions when the company is insolvent should be different in degree from those when the company is in vicinity of insolvency.

This part focuses on the UK and Australian jurisprudence as they have provided the most guidance on the question posed.[83] The UK cases deal with both the position that existed at common law and those that have been dealt with under s.172(3), which, as indicated earlier, codifies the common law that existed in the UK and which is similar, if not identical, to that applying in other common law jurisdictions.

In *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*[84] Mr Leslie Kosmin QC (sitting as a deputy judge of the High Court) dealing with a case where directors had failed to consider creditors' interests when their company was insolvent or close to it, said that :

> "In relation to an insolvent company, the directors when considering the company's interests must have regard to the interests of the creditors. If they fail to do so, and therefore ignore the relevant question, the *Charterbridge Corporation* test can be applied with the modification that in considering the interests of the company the honest and intelligent director must have been capable of believing that the decision was for the benefit of the creditors. In my view the *Charterbridge Corporation* test is of general application."[85]

Charterbridge Corporation[86] was a case, the reasoning of which has been accepted on many occasions by both UK and Commonwealth courts,[87] where the judge had to consider the duty of directors to act in good faith in the best interests of their company, in circumstances where the company was solvent. The decision in *Re Smith and Fawcett Ltd*[88] had earlier held that this duty was subjective as directors were obliged to act "bona fide in what they consider – not what a court may consider – is in the interests of the company…"[89] The test for determining whether directors acted properly was : did they believe that what they did was in the best interests of the company? If they had, then the directors had not acted in breach of their duties.

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83 Parts of the following are based on A. Keay, "Directors' Duties and Creditors' Interests" (2014) 130 *Law Quarterly Review* 443.

84 [2002] EWHC 2748 (Ch); [2003] B.C.C. 885.

85 *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] B.C.C. 885 at [87].

86 *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch. 62.

87 For example, see *Australian National Industries Ltd v. Greater Pacific Investments Pty Ltd in Liq (No 3)* (1992) 7 A.C.S.R. 176*; Linton v. Telnet Pty Ltd* [1999[NSWCA 33; (1999) 30 A.C.S.R. 465 at 471-473; *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 B.C.L.C. 598 at [91]; *Simtel Communications Ltd v Rebak* [2006] EWHC 572 (QB); [2006] 2 B.C.L.C. 571 at [104]; *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157 at [2823]; *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm) at [266].

88 [1942] Ch. 304.

89 *Re Smith and Fawcett Ltd* [1942] Ch. 304 at 306 per Lord Greene M.R.

While the focus is generally on the subjective consideration of the position of directors, in the *Charterbridge* decision Pennycuick J said that where the director against whom proceedings have been initiated had actually failed to consider whether the action that is the subject of complaint would be in the interests of the company, objective considerations came into play and a judge had to inquire whether an intelligent and honest man in the position of a director of the company involved, could, in the whole of the circumstances, have reasonably believed that the action was for the benefit of the company.[90] In *Colin Gwyer*, this approach was applied to where directors were subject to the duty to consider the interests of creditors. The judge said that if directors failed 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 challenged was for the benefit of the creditors.

It was also indicated in *Charterbridge* when a director states that he or she believed in good faith that what he or she did was in the best interests of the company, the court is not obliged to believe the director. Thus a court is not going to accept without question the evidence of a director asserts that he or she acted in good faith if other evidence does not support that state of affairs. Clearly it is harder for courts to accept a director's claim to have acted in good faith where he or she has benefitted personally from the impugned action.[91]

Courts can come to the conclusion that a director was not acting in good faith when he or she took a particular action, not only from a consideration of the evidence of the director, but also from an examination of objective matters,[92] such as the reasonableness of what the director did or did not do.[93] Jonathan Crow (sitting as a deputy judge of the High Court) said in his judgment in *Extrasure Travel Insurance Ltd v Scattergood*[94] that "the fact that his [the director's] alleged belief was unreasonable may provide evidence that it was not in fact honestly held at the time."[95] This can be applied to the situation where creditors' interests are to be taken into account, with the modification that if the court does not believe that a director acted in good faith in considering the interests of creditors and he or she did not act reasonably then the director is, prima facie, liable. The above approach was specifically approved of in the English case of *Re HLC Environmental Projects Ltd.*[96]

The courts[97] have made it clear when dealing with a solvent company that while it does not rule out a conclusion that directors were acting in good faith in what they

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90 *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch. 62 at 74.

91 *Regentcrest plc v Cohen* [2001] B.C.C. 494; [2002] 2 B.C.L.C. 80; *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 B.C.L.C. 598; *Roberts v Frohlich* [2011] EWHC 257 (Ch); [2012] B.C.C. 407; [2011] 2 B.C.L.C. 625. Also, see L. Strine et al, "Loyalty's Core Demand : The Defining Role of Good Faith in Corporation Law" (2010) 93 *Georgetown Law Journal* 629.

92 This approach has been invoked in the US : *Citron v Fairchild Camera and Instrument Corp* 1988 WL 53322 (Del. Ch.).

93 *Shuttleworth v Cox Bros and Co (Maidenhead) Ltd* [1927] 2 K.B. 9 at 23-24; *Westpac v Bell Group* [2008] WASC 239 at [4598].

94 [2003] 1 B.C.L.C. 598.

95 [2003] 1 B.C.L.C. 598 at [90].

96 [2013] EWHC 2876 (Ch) at [92].

97 *Regentcrest plc v Cohen* [2002] 2 B.C.L.C. 80 at 105; *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 B.C.L.C. 598.

have done, it might be harder for the directors to maintain good faith when the company has incurred a substantial detriment. The same is likely to apply when a company is in the vicinity of insolvency and the creditors have sustained a significant loss,[98] that is, where the directors have benefitted personally from what they have done.

So, by way of summary, if directors assert that they acted in good faith and considered the interests of creditors, and a court does not disbelieve[99] what they say then the directors' subjective view should be accepted, they will not be held liable because a court will not impose liability on directors under this provision for mistakes or acting, in what the court itself might regard, unreasonably.[100] However, if directors failed to consider whether the action that is complained of would be in the interests of the company's creditors,[101] the court has to ask whether an intelligent and honest person in the position of a director of the company involved, could, in the whole of the circumstances, have reasonably believed that the transaction was for the benefit of the creditors.[102]

So far so good, but we need to address a critical question before going any further, and that is : what is meant by considering the interests of creditors? A requirement that directors are "to consider the interests of the creditors" does not indicate exactly how directors should act in complying with the requirement to consider the interests of creditors. The fact of the matter is that most cases do not address this issue. They simply say that creditors' interests should be taken into account or considered and leave it at that. Historically, most of the cases appear to distinguish between where a company is insolvent and where a company is in financial difficulties short of insolvency, that is in the vicinity of insolvency. It is in the latter situation that, in the words of Richardson J of the New Zealand Court of Appeal, "greater difficulties of legal principle arise,"[103] and that is what the paper focuses on.

Unfortunately the existing case law is not totally consistent when determining the manner in which the directors are to discharge their obligation. On one side some cases say that the interests of creditors have to be regarded as paramount, just as they are when the company is insolvent. This is well-illustrated by the decision in *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*.[104] In this case the court did not distinguish between insolvency and cases where the company is in the vicinity of solvency. According to the deputy judge the creditors' interests were to be seen as

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98 *Roberts v Frohlich* [2011] EWHC 257 (Ch); [2012] B.C.C. 407; [2011] 2 B.C.L.C. 625. Also see, *Dryburgh v Scotts Media Tax Ltd* [2011] CSOH 147 at [94]

99 The judge in *Dryburgh v Scotts Media Tax Ltd* [2011] CSOH 147 at [94] did not think that the director had believed that his action was in the best interests of the company.

100 *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153 at [83]. Although the court did say that the directors might be held liable for breach of their duty of care if they did make mistakes or acted unreasonably."

101 This might include the situation where the court does not believe the directors when they assert that they did consider the interests of the creditors in good faith.

102 The employment of this approach was considered by the deputy judge in *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153 at [73], [88] as he had come to the conclusion that the directors did not consider the interests of the creditors; in fact they had demonstrated "wilful blindness" (at [83])..

103 *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453 at 463.

104 *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153 at [74].

paramount where there is a shift in the duties of directors.[105] "Paramount" means something that is more important than anything else,[106] so we can conclude that the creditors' interests are to be seen as pre-eminent. Thus, this would suggest that directors must put the interests of creditors before any other concern or interest, including those of the shareholders, and perhaps to the total exclusion of others' interests. Many subsequent cases have cited *Colin Gwyer* with approval on this point, but until relatively recently no cases approved of the statement concerning the way that the interests of creditors of a company are to be seen when the company is short of being insolvent. But the recent English decisions of *Roberts v Frohlich,*[107] *GHLM Trading Ltd v Maroo,*[108] and *Re HLC Environmental Projects Ltd*[109] approved of what *Colin Gwyer* said about the nature of the consideration that should be given to creditor interests. In *Re Idessa (UK) Ltd*[110] Lesley Anderson QC said that the interests of the creditors overrode those of the shareholders when the company was in financial difficulties,[111] and this suggests that the interests of creditors were to be seen as paramount. In *Re HLC Environmental Projects Ltd* the judge said that:

> "The underlying principle is that directors are not free to take action which puts at real (as opposed to remote) risk the creditors' prospects of being paid, without *first* having considered their interests rather than those of the company and its shareholders."[112] (my emphasis)

The judge seemed to be saying that the creditors' interests are to take precedence.

On the other hand there are cases which support the view that while directors must consider creditors' interests when the company is in the vicinity of insolvency, they are not required to put those interests before those of the shareholders. In *Re MDA Investment Management Ltd*[113] Park J indicated that when a company is in financial difficulties, although not insolvent, the directors' duties owed to the company are extended so as to include the interests of the company's creditors as a whole, in addition to those of the shareholders. This statement appeared to be cited with approval in *Re Kudos Business Solutions Ltd.*[114] Lewison J in *Ultraframe (UK) Ltd v Fielding*[115] took the same approach and said that when a company is in financial difficulties the duties which the directors owe to the company are extended so as to encompass the interests of the company's creditors as a whole, as well as those of the

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105 [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153 at [74].
106 J. Pearsall, *New Oxford Dictionary of English* (Oxford, O.U.P., 2001) at p.1346.
107 [2011] EWHC 257 (Ch); [2011] 2 B.C.L.C. 625 at [85].
108 [2012] EWHC 61; [2012] 2 B.C.L.C. 369 at [165]. In fact Newey J. specifically stated that where a company was doubtfully solvent or on the verge of insolvency then the interests of the company were to be identified with those of the creditors (at [162]).
109 [2013] EWHC 2876 (Ch) at [92].
110 [2011] EWHC 804 (Ch); [2012] B.C.C. 315 at [54] (sub nom *Burke v Morrison*).
111 Many years ago, in *Australian Growth Resources Corp Pty Ltd v Van Reesema* ((1988) 13 A.C.L.R. 261 at 268) King C.J. of the South Australian Supreme Court took a less creditor-oriented approach when he said (in a Full Court decision, and the other judges agreed with him) that if a "company's financial position is precarious, the interests of the creditors *may* become the dominant factor in what constitutes 'the benefits of the company as a whole.'" (my emphasis).
112 [2013] EWHC 2876 (Ch) at [89].
113 [2004] 1 B.C.L.C. 217 at 245; [2004] B.P.I.R. 75 at 102.
114 [2011] EWHC 1436 (Ch); [2012] 2 B.C.L.C. 65 at [43].
115 [2005] EWHC 1638 (Ch).

shareholders.[116] But it is not just the English cases that have taken this approach. In the Australian case of *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*[117] Owen J said that where a company is in the vicinity of insolvency the shareholders retain their interest in the company's affairs, as the creditors' interests do not supplant those of the shareholders.[118] In the New Zealand Court of Appeal in *Nicholson v Permakraft (NZ) Ltd*[119] a case where the company was said to be nearing insolvency[120] at the time of the alleged breach, Cooke J said that he did not think that the interests of the shareholders should be put aside.[121] It should be noted that the Australasian cases are not inconsistent with the approach adopted where a company is insolvent. In the seminal case of *Walker v Wimborne*[122] Mason J of the High Court of Australia said that the directors of an insolvent company in discharging their duty to the company must take account of the interest of its shareholders *and* its creditors. He did not say that the interests of creditors supplanted, or became pre-eminent with respect to, those of shareholders. This point was taken up by Owen J at first instance in *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*.[123] His Honour referred to comments of Mason J and said that :

> "I do not read any of these statements [which were set out in the Australian cases] as demanding that the interests of creditors be treated as paramount. They emphasise the importance of treating the position of creditors with due deference…."[124]

His Honour was clearly against any general requirement making the interests of creditors paramount, although he did accept that on occasions, depending on the circumstances of the company, it was necessary that the creditors' interests should be seen as paramount.[125] When his decision went on appeal one of the appeal judges, Drummond AJA, specifically agreed with his Honour's comments.[126] In his judgment at first instance Owen J seemed to suggest that when considering creditors' interests directors had to engage in a balancing exercise where the risk to creditors could be included as one of several matters to be taken into account by the directors, and where there was a greater the risk to creditors, the more directors should take those considerations into account.[127] It must be noted that in the highly-regarded and much cited decision of *Kinsela v Russell Kinsela Pty Ltd,*[128] Street CJ of the New South Wales Court of Appeal said that if the company is insolvent the interests of the creditors intrude and the creditors become prospectively entitled to displace the power of the shareholders and directors to deal with the company's assets.[129] The general

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116 *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1304].
117 *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239 at [4436].
118 [2008] WASC 239 at [4436].
119 (1985) 3 A.C.L.C. 453.
120 (1985) 3 A.C.L.C. 453 at 459.
121 (1985) 3 A.C.L.C. 453 at 460.
122 (1976) 137 C.L.R. 1 at 7.
123 [2008] WASC 239 at [4436].
124 [2008] WASC 239 at [4438]-[4439].
125 [2008] WASC 239 at [4440].
126 *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157 at [2046]
127 *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239 at [1436]-[1439].
128 (1986) 4 A.C.L.C. 215; (1986) 10 A.C.L.R. 395.
129 *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215 at 221; (1986) 10 A.C.L.R. 395 at 401.

thrust of what Street CJ stated, does appear to envisage the creditors supplanting the shareholders as the objects of the directors' attention and concern, thus the Australian law might not be totally clear on the issue.

Arguably focusing solely on creditors' interests when a company is in the vicinity of insolvency might be a less demanding task rather than perhaps some sort of balancing of the interests of shareholders and creditors; the directors can just focus on the creditors' interests. Yet, while a paramountcy approach might be able to be justified when a company is insolvent as the company's assets are effectively the creditors, with insufficient funds available to pay off all creditors, if a company is not insolvent then perhaps it is fair to say that creditor interests should not override those of the shareholders totally as the point has not been reached where it can be said definitively that the creditors are not able to be paid in full. In fact, they *might* be paid in full and there is more chance of them receiving all of their money where the company has not fallen into an insolvent position. Also, there is perhaps some strength in the view that the directors' focus is to be on shareholders in solvent companies, a balancing of shareholders and creditors interests when the company is in the vicinity of insolvency and a focus on creditors interests alone when a company is insolvent. This provides a progressive change in the duties and does not require directors to move suddenly from focusing on shareholder interests to those of the creditors; the requirement to balance shareholder and creditor interests in the vicinity of insolvency does provide for a possible transition. This might be supported by the fact that in *Kinsela v Russell Kinsela Pty Ltd,*[130] Street CJ opined that wholly differing considerations might come to the fore depending on the degree of a company's financial instability.[131] This suggests that how the directors discharge their duties when a company is in the vicinity of insolvency and what they do when the company is insolvent should be different. Perhaps even how directors behave in the vicinity of insolvency depends on the actual state of the company's finances.

2. *Assuming paramountcy*

If creditors' interests are paramount, then this will involve, as suggested above, the directors being preoccupied with the interests of the creditors, and ignoring the interests of shareholders. In considering any action or decision the first thought of the directors should be to determine how it would affect the creditors. Perhaps it is possible to state that everything that the directors do must provide an advantage to creditors. The consequence is that the company's affairs are to be managed in such a way that an enhancement of the wealth of creditors is assured. According to Mr Leslie Kosmin QC in *Colin Gwyer v London Wharf (Limehouse) Ltd*,[132] directors who are in the process of taking into account the interests of creditors have to consider the impact of any decision on the ability of the creditors to recover the sums due to them from the company.[133]

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130 *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215; (1986) 10 A.C.L.R. 395.

131 (1986) 10 A.C.L.R. 395 at 404.

132 [2002] EWHC 2748; [2003] 2 B.C.L.C. 153.

133 [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153 at [81], a view also expressed by Lesley Anderson Q.C. (sitting as a deputy High Court judge) in *Re Idessa (UK) Ltd* (sub nom *Burke v Morrison*) [2011] EWHC 804 (Ch); [2012] B.C.C. 315 at [120].

"Paramountcy cannot simply entail directors refraining from disposing of assets improperly or diverting property to insiders in the company, which are obviously actions detrimental to the creditors (and arguably to the shareholders save where all of the insiders constitute the entire shareholding body), but it extends to all of the duties that are owed, and functions undertaken, by directors."[134]

What this will involve in any company and any particular situation in which a company finds itself will obviously vary, but it could entail the reduction of expenditure and "tightening the corporate belt."[135] In others it might involve not commencing a project unless it was adequately funded,[136] or seeking refinancing that could support either a continuation of profitable trading of the company or the successful reorganisation of the company's affairs, as the termination of trading followed by the disposal of the assets of the companies on a forced sale basis could lead to heavy losses for the creditors.[137] Directors need to realise that the only chance creditors have of being paid in full lies in a continuation of trading, and this will require directors to assess carefully the likely success of a any proposed restructuring plan given the state of the company's financial affairs and the information and advice available to them.[138] Importantly what must be at the forefront of the minds of the directors is the benefit for the creditors and not the continuing viability of the business,[139] or the interests of others, such as the employees,[140] however meritorious that might seem to be. Yet in other cases a company's position and prospects might be so hopeless that the directors cannot reasonably expect the company to survive and that it is proper to place the company into some form if insolvency regime, such as administration or liquidation.

In *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*[141] Owen J said if a company is insolvent then the directors should cease trading, and whether the same should occur if the company was in the vicinity of insolvency might, according to the judge, depend on how "near" insolvency is,[142] but that clearly suggests that in some cases the cessation of trading is required even where the company is short of insolvency. Placing the company into a formal insolvency regime holds some appeal for directors as it is likely to safeguard them from any possible proceedings, but that same action might be perceived as constituting a premature end for companies that have potential to recover. Also, in many jurisdictions it means placing the fate of the company in the hands of an independent insolvency practitioner. Whether it is in fact appropriate or not to end trading or place the company in an insolvency regime is

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134 A. Keay, "Directors' Duties and Creditors' Interests" (2014) 130 *Law Quarterly Review* 443 at 458

135 *Re Idessa (UK) Ltd* [2011] EWHC 804 (Ch); [2012] B.C.C. 315 at [92], [112] (sub nom *Burke v Morrison).*

136 For example, see *Roberts v Frohlich* [2011] EWHC 257 (Ch); [2012] B.C.C. 407; [2011] 2 B.C.L.C. 625.

137 *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 B.C.L.C. 218 at 228.

138 In relation to the issue of restructuring in times of insolvency or near insolvency, see the very thought-provoking article by Anil Hargovan and Jason Harris, "For Whom the Bell Tolls : Directors' Duties to Creditors After Bell" (2013) 35 *Sydney Law Review* 433

139 *Sydlow Pty Ltd v Melwren Pty Ltd* (1993) 13 A.C.S.R. 144.

140 But see the decision of Hoffmann J in *Re Welfab Engineers Ltd* [1990] B.C.C. 600.

141 *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239 at [838].

142 [2008] WASC 239 at [838].

likely to depend heavily on the financial position of the company and its future prospects, including whether there is any new financing available.

3. *Assuming no paramountcy*

Let us now consider the situation where the view is taken that the creditors' interests are not to be taken as paramount when the company is in the vicinity of insolvency. One, therefore, assumes that both the shareholders and creditors interests have to be taken into account, and in some jurisdictions, such as, possibly South Africa, this might be widened to consideration of broader interests. This is a vexed issue. As one American court put it in relation to the law as it applied, at least in the State of Delaware: "the extent to which directors of putatively insolvent corporations can continue to advance the interests of stockholders without violating their fiduciary duty to the corporate entity or to creditors remains hazy …".[143] The real issue is : how much prominence are the creditors' interests to be given? The problem for directors is that when a company is in a financially parlous state the interests of shareholders and creditors can be "starkly divergent."[144]

One possible way to resolve the issues raised above is for directors to balance the interests of creditors and shareholders. In jurisdictions which favour directors being required at all times to balance a range of stakeholder interests, the issue would be : how much prominence, if any, will be given to creditor interests? It might be said that if there is to be a real shift in directors' duties, then creditors' interests must be given greater consideration among all of the stakeholders' interests, compared to where the company is not in the vicinity of insolvency.

In the context of vicinity of insolvency, what does balancing actually mean for directors when they are concerned with running the company's business? Balancing interests is difficult, as many have pointed out in relation to stakeholder theory in corporate governance,[145] as it requires directors to balance the interests of all stakeholders when managing the affairs of the company. But directors in companies that require a range of stakeholder interests to be considered seem to manage it and even in many companies in Anglo-American jurisdiction which largely are required to favour shareholder interests alone, directors do appear to take into account various stakeholder interests,[146] and UK directors are required to do so by s.172(1) of the Companies Act.

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143 *Jewel Recovery LP v Godon* 196 B.R. 348 at 355 (1996).

144 *Prod. Res. Grp. LLC v NCT Crp Inc*. 863 A. 2d 772 (Del. Ch. 2004) at 790 and referred to in A. Hargovan and J. Harris, "For Whom the Bell Tolls : Directors' Duties to Creditors After Bell" (2013) 35 *Sydney Law Review* 433 at 437.

145 W. Leung "The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 *Columbia Journal of Law and Social Problems* 589; E. Sternberg "The Defects of Stakeholder Theory" (1997) 5 *Corporate Governance* 3 at 6; A. Sundram and A. Inkpen "The Corporate Objective Revisited" (2004) 15 *Organization Science* 350 at 353; A. Keay "Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model" (2008) 71 M.L.R. 663 at 677-678.

146 See, A. Keay and R. Adamopoulou, "Shareholder Value and UK Companies : A Positivist Inquiry" (2012) 13 *European Business Organization Law Review* 1; M. Anderson, et al., 'Shareholder Primacy and Directors' Duties: An Australian Perspective', (2008) 8 *Journal of Corporate Law Studies* 161.

It may well be difficult for directors to know whether to favour shareholders or creditors in any particular situation. But, provided directors can demonstrate that they have acted in good faith and endeavoured to take creditors' interests into account then a court might feel that it is unreasonable to find them liable. Many of the cases where directors have been held liable have involved directors clearly not acting in good faith because they engaged in excessive risk-taking or entered into transactions of either an improper nature or ones that are of highly questionable merit. Directors will have to assess the fairness and appropriateness of all investment opportunities when they are subject to the obligation to consider creditor interests.

In balancing one would think that directors need to endeavour to effect a reasonable balance between excessive risk and excessive caution. If the directors were only concerned for shareholder benefits they might be inclined to indulge in excessive risk, while if they were focusing on benefitting the creditors solely, directors would probably engage in a far more cautious approach, thereby perhaps leaving potential value unrealised. The result is that directors should probably not be acting too cautiously, an approach which might see the company passing up good opportunities, but they must ensure that they carefully assess the operating strategy of the company in light of creditors' interests. Hence, "the directors must undertake a balance so that creditors are protected and at the same time the company's ability to innovate and take some appropriate risks is not totally or unreasonably proscribed."[147] Such an approach chimes with the comments of the court in *Facia Footwear Ltd (in administration) v Hinchliffe,*[148] a case involving a claim that directors had failed to take into account creditors' interests. Sir Richard Scott V-C acknowledged that in continuing trading the directors were taking a risk, but his Lordship went on to say that "the boundary between an acceptable risk that an entrepreneur may properly take and an unacceptable risk…is not always, perhaps not usually, clear cut."[149] Street CJ in *Kinsela v Russell Kinsela Pty Ltd*[150] put it neatly :

> "Moreover, the plainer it is that it is the creditors' money that is at risk, the lower may be the risk to which the directors, regardless of the unanimous support of all the shareholders, can justifiably expose the company."[151]

VI Conclusion

An approach to the problem of companies operating in the vicinity of insolvency that has been embraced by many common law jurisdictions is to cause the duties of directors to shift to the point where they have to consider the interests of the creditors. This constitutes quite a sea change for directors of companies in common law countries because the predominant approach in these countries is to require directors to seek to benefit shareholders, and in fact s.172(1) of the UK's Companies Act 2006, overtly requires it.

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147 A. Keay *Company Directors' Responsibilities to Creditors* (Abingdon, Routledge-Cavendish, 2007) at 245-246.

148 [1998] 1 B.C.L.C. 218.

149 [1998] 1 B.C.L.C. 218 at 228.

150 *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 A.C.L.R. 395.

151 (1986) 10 A.C.L.R. 395 at 404

The paper has explained the development of the law that exists in relation to this shift in the nature of duties as well as identifying the various approaches implemented in EU Member States to address the issue of insolvency and near insolvency in companies. The paper has focused on identifying the difficulties that do exist if jurisdictions do decide to adopt a shift of duties strategy. The primary problems involve determining when the shift occurs and if there is a shift, and what does that entail as far as the behaviour of the directors is concerned? Hitherto the approach of the courts has not been overly precise in relation to the first issue. They have been content to find that the company is in some form of financial difficulty but they have not specified any particular criteria that must be fulfilled before they will decide that there should have been a shift in the directors' duties.

As far as the second issue is concerned there is some uncertainty whether the interests of creditors should, on a company in the vicinity of insolvency, be regarded as paramount or simply taken into account along with the interests of shareholders, and, possibly in some countries, the interests of other stakeholders. In jurisdictions where directors are required to balance the interests of a range of stakeholders the shift in duties leading to a requirement that creditors' interests must be considered might not provide as many problems as they do for courts which have to uphold law that mandates the interests of the shareholders be given precedence.

Undoubtedly, the employment of the shift in duties approach has led to some degree of creditor protection, even if we cannot say, empirically, to what extent. There is evidence from several cases that creditors have benefited from liquidators taking action against directors for a failure to embrace the shift in their duties before their company ended up in liquidation, and in many of these cases creditors would not have benefited were it not for the development of the jurisprudence on a shift in duties.

Jurisdictions that presently do not embrace a shift in directors' duties when companies enter the vicinity of insolvency will need to examine the development of the law that has been discussed in this paper to determine whether they feel that the approach would be worth implementing. It might be an approach that could, conceivably, be added to the present protections that are designed to benefit creditors when a company is insolvent and/or in the vicinity of insolvency, but in doing so the problems that have been discussed here need to be taken into account.