

Introduction and client care issues

[Law](#), [Contract Law](#)



Introduction

Charlotte Ann Ltd (CA) has two directors (A and B) both of whom are now seeking advice on several different issues in relation to CA, as well as a wholly-owned subsidiary CAFinance which is going into insolvency. Firstly, and prior to identifying key issue and the legal rules that will apply, it is necessary to consider the basic client care factors, to ensure that instructions are being received from an authorised party; in particular, consideration needs to be given as to whether or not advice is being given to the individual directors, or whether the advice is being sought on behalf of the company. On the face of it, it may seem to be all the same entity, but there are potential distinctions, particularly given the fact that one of the key issues to be discussed is directors' duties towards the company. It is noted that for a considerable period that Ebenezer was also a director of the company and, although he has now left as a director, this does not exonerate him from any breaches that he may have undertaken, during his time as director. It may be that an agreement was entered into when Ebenezer left as a director and as this has not been presented here, it is assumed that no such contract exists and therefore the advice being provided will be on the basis that no such contract does, in fact, exist.

The advice here is broadly split into two areas, the first looking at directors' duties and, in particular, the impact of Ebenezer's behaviour; the second part looks at the insolvency of the subsidiary and related issues.

Directors Duties Owed by E to the Company

All three directors A, B and E (although E is not a current director) are required to comply with the statutory directors' duties, as established and codified by the Companies Act 2006, sections 170 – 180. These will be looked at, first, before applying them to the situation in relation to E and his contact with a long-standing customer, Gurdip (G), and the relationship that emerged between E and Robert with the company accounting practices, as well as an analysis of the situation and any impact that this now has on A and B, based on any duty or liability that they may have to the company.

In accordance with section 171, directors are required to act within their powers and are only allowed to act within the boundaries of the company's constitution. Secondly, in accordance with section 172, directors are under a duty to promote the “ success of the company the benefit of its members”. This requires the directors to ensure that the decisions they make are done in such a way that it benefits the company, in the long run. Furthermore, the directors are required to ensure that they act fairly between the members[1].

Section 173 requires each director to exercise independent judgement; however, it should be noted that the duty will not be breached, if some form of agreement has been entered into between the directors in total freedom but does have the effect of meaning they not each director is acting with independent judgement, at all times.

Crucially, section 174 states that directors are required at all times to exercise reasonable skill, care and diligence, with the level of skill that would be expected of another individual with a similar level of knowledge, as well

as a general level of care that would generally be expected to be shown by a director in a similar position. Broadly speaking, the way in which reasonable skill, care and diligence is expected to be shown is the same as the approach taken in section 214 of the Insolvency Act 1986. The leading and relevant case in this regard is that of *Re City Equitable Fire Insurance*[2], where it was stated that there are three propositions that would apply when ascertaining the level of skill and care which are expected to be shown by the director. Firstly, it is accepted that the director would not be expected to show a level of skill and care above that which his own level of knowledge suggests would be appropriate. Secondly, there is no requirement on the director to give continuous attention to the situation within the company and there is an expectation that the directors may look away from the company for periods of time. Thirdly, when it comes to exercising their duty, it is acceptable for the director to pass some of their responsibilities on to third parties, provided the selection of the third party is done with reasonable skill and care[3].

Section 175 states that each director must avoid conflicts of interest, and furthermore that they must inform their fellow directors of any possible conflict, before the transaction, or as soon as is reasonably practicable in relation to a particular transaction, if there is going to be a potential conflict of interest. Fellow directors are able to authorise this conflict, provided they are fully informed of the situation.

Finally, section 176 states that a director is not able to accept benefit from third parties. Making a secret profit is prohibited, if the profit is being made by virtue of his position as director[4]. It is noted, however, that no breach

will arise, if they could not reasonably be expected that accepting the benefit would result in a conflict-of-interest, i. e. if the situation was of no interest to the company[5].

The consequence of a breach is also relevant to the discussion, here.

Although the 2006 Act does not specifically state the remedies that are available, there is now a procedure in place allowing for derivative action to be taken by the shareholders on behalf of the company, in the event that it remains the case that a director in breach of duty would be required to account for profits to the company and may find themselves personally liable for any losses.

E's Arrangement with G – Breach of Duty?

Bearing in mind the situation here and the fact that E entered into a transaction with G which provided him with a profit during his time as a director, it is suggested that E has undertaken several activities that would be in breach of his director's duties. As noted above, it would be necessary to ensure that no contract has been entered into when he left as a director, which would remove him from responsibility for the action that he undertook while acting as a director. On the assumption that no such agreement exists, E would remain responsible for the activities when he was the director of the company. However, by entering into a contract with G which enabled him to make substantial personal profit, it could be argued by E that, as the transaction involves petrol cars, the transaction would be of no interest to the company and the discount provided to the customer was no greater as a result of the transaction, meaning that the company had not, in fact, lost out

at all. Despite this, there is sufficient suggestion that having this underlying contract with G would ultimately result in a conflict of interest that should be declared. Failure to declare this would require E to account for any profit that he had made to the company, and the actions of the other two directors, namely A and B could enforce on behalf of the company[6].

Ebenezer and Robert – Breach of Duty?

Several financial errors were made as a result of the activities of Robert who was employed as the individual in charge of the accounts. This raises the question of whether or not it was reasonable for A and B to relinquish responsibility to E, in order to oversee the work of Robert and, if so, whether he could be held responsible for the errors that have taken place. This issues deals with the area of reasonable skill and care. As noted by Section 174, it is not required for the directors to give continuous attention and it is acceptable to allow third parties to take on board some of the tasks, provided the selection of the third party is done with sufficient skill and care. It is suggested, based on the interpretation of Section 174, that it was acceptable for A and B to allow E to oversee all aspects of the accounts of the business and this would potentially render E liable for the errors that have taken place. Further information would be required in order to understand whether or not he had acted reasonably in accepting Robert's position and whether a director with a similar level of skill and care would have taken a more proactive approach or would have selected a different third party.

On balance, it is suggested that E has erred in failing to oversee Robert appropriately and simply signing off the accounts, without investigating these further as would be reasonably expected of a director in his position. This again could result in E being personally responsible to the company for the losses as a result of Robert's failures, and E's inability to deal with this and to act appropriately.

Insolvency Process

The subsidiary company, CA Finance is now deemed to be insolvent and although A was the sole director, B was also involved in the management of the company and could potentially be considered to be acting as a shadow director, as he was giving instruction. This is because, if he were a director in accordance with section 251 of the 2006 Act, this would potentially render either A or B liable for any mismanagement during the insolvency process, which is largely governed by the 1986 Act.

Compulsory liquidation takes place in accordance with section 122 of the 1986 Act and can be initiated by a creditor who is owed ? 750 or more. In this case, a liquidator has been appointed, as they have reasonably wide discretion to manage the liquidation and to commence action against the directors, if they have acted in an incorrect manner. As soon as the official receiver takes over the director's appointments are terminated[7].

In accordance with section 132, the official receiver is required to investigate the reason why the company had become insolvent and the activities of the company, prior to insolvency. One particular issue that the official receiver

may deal with in the context of the facts presented here is that the directors have transferred many of the assets of the failing company into the parent company, immediately prior to the insolvency of the subsidiary company. Although there is some factual debate as to whether or not the directors understood the transfer of these assets would result in insolvency, nonetheless it could be argued that this was undertaken in contemplation of insolvency and would potentially be clawed back by the official receiver, on behalf of the creditors of the company.

There are several headings under which the official receiver could potentially claw back money that has left the failing company, prior to insolvency. These include, transaction at undervalue, preference to certain creditors, extortionate credit transactions, the avoidance of floating charges, transaction that are aimed at defrauding creditors, misfeasance and either fraudulent or wrongful trading. In accordance with section 423, where the aim of the transaction was to put assets beyond the reach of the creditors, this could be considered to be a transaction that was aimed at defrauding the creditors and this would involve an analysis of the overall situation and whether or not this was the underlying purpose of such a transaction. Where it is deemed to be the case, the transaction could be reversed and the assets returned to the failing company, in order to be diverted amongst the creditors.

Claim by F Against CA

It is also noted that Fozia (F) has suffered a personal injury and wishes to take an action against the company that is now insolvent. The question,

therefore, arises as to whether or not it is possible to bring such an action against an insolvent defendant, or whether there is some other forms of recompense available to F.

In order for F to bring an action against the insolvent company, it would require permission from the court[8]. Historically, however, it is accepted that the courts will generally allow such an action to be commenced and this will then allow F to become a creditor of the company for the amounts owed to him.

A question arises, therefore, as to whether the parent company can be held responsible for the debts of the subsidiary. It may be possible for a creditor such as F or any other creditor to attempt to pierce the corporate veil and to look through the arrangements within the subsidiary to make a claim against the parent company. In order to determine whether this will be appropriate in this particular situation, the facts relating to the activities of the two companies prior to insolvency will need to be ascertained, including whether the assets were transferred at net book value and how much control the parent company actually had over the subsidiary. More information needs to be provided, in order to ascertain whether the assets were transferred out of the business as part of the restructuring and whether this was done in a way that could be deemed to be a means of removing the assets from the grasp of the creditors. It would therefore be appropriate to lift the corporate veil and make the parent company responsible and may indeed allow for the claw back of the transaction by the official receiver[9].

Furthermore, concerns in relation to the claim by F need to be looked at in a similar context, in order to ascertain how much control the parent company had over the insolvent subsidiary, as to whether it would be appropriate to attach a claim to the parent company, or whether F would be simply viewed as another potential creditor against the assets of the company, which may be greater once the assets have been clawed back. Factors that might indicate that the corporate veil should indeed be pierced include the directorship between the two companies and therefore the relatively strong indications suggest that the parent company would, in this case, be deemed to be responsible for the actions of the subsidiary and may therefore be called upon to meet with the debts of the company.

Group Restructure– Potential Insolvency Issues

Bearing in mind the previous analysis, it is suggested that the restructure undertaken by the subsidiary company immediately prior to insolvency would be subject to being reversed by the official receiver, as there is indication that this transaction was undertaken in order to defraud the creditors. The directors themselves may be liable for their own activities relating to the insolvent company, if it could be shown that they have acted in misfeasance, in accordance with section 212 of the Insolvency Act 1986. It is suggested here that both A and B could be liable, as they were acting in the capacity of directors, albeit one as a shadow director[10]. In order for them to be individually liable under section 212 and for the individual to be liable to repay towards the assets of the company, it will be necessary to show they were culpable in some way for the insolvency of the company;

therefore, more evidence would need to be obtained as to how the decisions were made in the immediate run-up to the insolvency of the company[11].

On balance, it is likely that the assets will be returned to the insolvent company, in order to pay off the debts owed to the creditors, as it can potentially be shown that the transaction undertaken was a means of removing the assets from the grasp of the creditors. If there was evidence that the assets were transferred at net book value, it may be possible for the company to argue that the claw back should not take place.

Furthermore, it is also argued that F would be likely to be able to bring an action against the insolvent company, provided he obtained the necessary court permission. It is also necessary to consider whether the corporate veil should be pierced and an action commenced against the parent company. This will depend on the facts of the case and whether or not it is reasonable to allow for the corporate veil to be pierced in this way, based on the true nature of how the company is organised and the level of control exercised by the parent company.

Overall Conclusions

It is concluded, overall, that A and B would be able to bring an action on behalf of CA against E as a director (albeit now a retired director) for his breaches of duty in relation to both his failure to declare a conflict-of-interest and a personal profit in relation to the transaction with G and also the failure to oversee the work of Robert in producing the accounts. It would be possible

to claim that he should account for the profit and the money paid back into the company.

Secondly, the insolvency of the subsidiary company is likely to result in the assets that were transferred out in order to remove them from the creditors being clawed back by the official receiver. Furthermore, the action being commenced by F (which will require the permission of the court) is likely to be attached to the parent company, as the corporate veil should be lifted, due to the fact that the parent company held so much power over the subsidiary company and had commonality of directors.

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