Pursuing fraudulent directors: options for insolvent companies

THE PROVISIONS OF THE COMPANIES ACT 2006 HAVE sought to codify and expand upon the current common law and equitable duties owed by company directors. While it is hoped that these provisions will clarify the scope of such responsibilities, there will inevitably be a minority of directors who will continue to disregard their duties and pursue dishonest schemes. Such behaviour is of particular concern in small, private companies where the director in question often has full control over the management of the business. The wrongful acts may only come to light after the company has been forced into financial difficulty and the director may hope that a sophisticated and comprehensive fraud will leave the company with little appetite or resources to litigate the matter.

This briefing examines a number of ways in which the law has developed and can be used to assist impecunious and insolvent companies in the pursuit of fraudulent directors.

INSOLVENCY AND CREDITOR CLAIMS

Those managing a company left in financial difficulty as a result of a director's misconduct will first need to consider the company's solvency and the associated issues. The directors may conclude, following advice, that it is necessary to place the company into administration or liquidation. In terms of pursuing claims against the directors, the appointment of an insolvency office-holder can often be a distinct advantage. As explained in this briefing, a liquidator, for example, has vested in them a wide range of statutory powers and causes of action that are not available to solvent companies. These in turn can facilitate the prosecution of past and present directors.

However, the management of the company may want to avoid an insolvency process and look to consider how the company's financial status can be preserved. As an alternative to insolvency, a company may be able to ask the court to sanction a compromise arrangement entered into with its creditors or a class of creditors pursuant to ss895-899 of the Companies Act 2006 (formerly s425 of the Companies Act 1985). Such an arrangement was recently approved by the court in *Langbar International Ltd* [2006].

Compromise arrangements – *Langbar*

A number of Langbar's shareholders had purchased shares in reliance on market announcements misrepresenting the company's asset position. The shares were subsequently suspended from trading on the Alternative Investment Market and Langbar was exposed to potential and significant claims from the shareholders for their resulting losses.

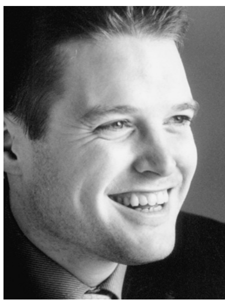
Under the terms of the compromise arrangement, the shareholders agreed not to bring proceedings against Langbar and also agreed to assign to Langbar any claims that they may have against the directors believed to be ultimately responsible. In return, Langbar was obliged to pursue both the company and shareholder claims against the directors at its own cost and to distribute the net proceeds in accordance with the terms of the arrangement.

As a result, Langbar was able to protect itself from potential insolvency and at the same time strengthen the basis and scope of the claims brought in its name against the directors.

LITIGATION FUNDING

Those acting on behalf of a company in financial difficulty will then need to consider how to fund any potential claims against a dishonest director. Often, they will need to look to third parties to help fund the costs of litigation in return for a percentage of any damages awarded.

Traditionally, the English courts have been reluctant to sanction the support of claims by independent parties with no legitimate interest in the outcome. As an exception, it is now reasonably well established that insolvency office-holders can obtain funding from one or more of the company's creditors with a view to prosecuting directors and restoring the company's assets. In addition, s58 of the Courts and Legal Services Act 1990 permits liquidators and ›



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administrators to enter into conditional fee agreements (CFAs) for their legal fees.

There are ways, therefore, in which insolvent companies can finance litigation. But what if the creditors are not prepared or able to fund a claim? And what if the company is not yet insolvent? The issue then arises as to whether those acting on behalf of the company can seek assistance from, for example, a professional funder who has no interest in the litigation other than a desire to make a return on their investment.

As a result of the archaic laws of maintenance and champerty, the concept of third-party funding outside the insolvency field is largely undeveloped in this jurisdiction. More recently, however, the English courts have taken the view that third-party funding is now acceptable in the interests of justice – especially where the prospective claimant is unable to fund their claim by any other means (see in particular the decision of the Court of Appeal in *Arkin v Bouchard Lines* [2005]). In addition, the Civil Justice Council issued a report in June 2007 – *Improved access to justice: Future funding of litigation* – recommending that, subject to certain safeguards, third-party funding should be recognised as an acceptable option for mainstream litigation. Professional funding is now on the increase therefore, and this should afford companies in financial difficulty a further opportunity to ease the costs burden associated with litigation against errant directors.

RETRIEVAL OF COMPANY INFORMATION AND PRESERVATION OF ASSETS

In order to both comply with their statutory functions and to consider the prosecution of incompetent or dishonest directors, insolvency office-holders will need to collate information and documents relating to the company's affairs (and also to the assets belonging to the individual director). However, the relevant information is often in the possession or knowledge of the director, who may not want to volunteer the same to those now running the company.

The fact that a director has shown a propensity to act dishonestly may entitle those acting on behalf of the company to seek injunctive relief at the point at which the proceedings are issued. In addition to prohibiting the dissipation of assets pending trial, such relief (which is available to both solvent and insolvent companies) is likely to contain provisions requiring the defendant director to disclose information and documents evidencing personal assets. In appropriate circumstances, a search order may also be granted allowing the claimant access to the defendant's premises for the purpose of collating and preserving the relevant documents.

It should be noted, however, that the court is unlikely to extend the scope of such relief to cover the disclosure of company documents. For this purpose, the relevant office-holder can rely on the provisions of ss234-236 of the Insolvency Act (IA) 1986. These allow the office-holder to apply for orders requiring persons to deliver up company property (s234) and to attend at court for an examination on oath as to the affairs of the company (s236) and also impose on former directors and employees a statutory duty to co-operate with the office-holders by giving them such information as may reasonably be required (s235).

Collating information – *Daltel Europe Ltd (in liquidation) & ors v Makki [2005]*

Daltel provides a useful illustration of the English court's ability to assist an insolvent company in collating documents and information from a former director.

Daltel was owned and controlled by Mr Makki. It was placed into compulsory liquidation on the petition of its major creditor. A liquidator was appointed who discovered that substantial payments had been made to Mr Makki from Daltel's bank account. There did not appear to be any commercial justification for these payments and proceedings were issued against Mr Makki (including a claim for wrongful trading under s214 IA 1986 – see below). In conjunction with these proceedings, the liquidator obtained freezing and extensive search orders against Mr Makki. The costs of that action were underwritten by Daltel's major creditor.

Shortly after the issue of proceedings, the liquidator also applied under s236 IA 1986 for the examination on oath of Mr Makki regarding the company's affairs. This application was opposed by Mr Makki on the grounds that it would be oppressive in light of the concurrent civil litigation. This argument was rejected by the court and the application for an examination succeeded. It was held by the judge in that case that the fact that proceedings were pending against Mr Makki, including very serious allegations of fraud, could make it oppressive to order his examination in advance of the trial, but this consideration may be (and was here) outweighed by the liquidators' need for information to enable them to get on with their primary function of identifying and getting in the company's assets. This was even though it was recognised by the court that the answers given by Mr Makki might inevitably assist the liquidators' prosecution of the civil proceedings.

Arkin v Bouchard Lines [2005] EWCA Civ 655

Daltel Europe Ltd (in liquidation) & ors v Makki [2005] EWHC 726 (Ch)

Langbar International Ltd [2006] (Unreported, 9 November 2006)

Smith New Court Securities Ltd v Citibank NA [1997] AC 254 HL

Standard Chartered Bank v Pakistan National Shipping Corporation (Nos 2 and 4) [2003] 1 AC 959 HL

POTENTIAL CLAIMS AGAINST DIRECTORS

A director may abuse their position of trust and divert company funds to a personal account. In such circumstances, a solvent company could, for example, bring a claim against that director for breach of fiduciary duty or on the basis of knowing receipt of trust money.

However, in the event that the company is wound up, a subsequently appointed liquidator would have vested in them a number of additional and powerful causes of action that may be applicable to that particular director. These include claims against past and present directors for fraudulent and wrongful trading (ss213 and 214 IA 1986 respectively) and claims relating to the reversal of transactions at an undervalue (s238) and preferences (s239). Such causes of action can establish or widen the scope of a director's liability, which in turn may assist the office-holder to obtain a successful judgment and recover assets for the ultimate benefit of the company's creditors.

THE APPROACH OF THE COURTS

Notwithstanding a resolution of any funding issues, the prospect of expensive and protracted litigation can act as a disincentive to potential claimants. The English courts have traditionally imposed high standards of pleading and proof in cases involving dishonesty and unscrupulous directors may seek to drag out or complicate the proceedings in order the encourage an early or favourable settlement.

In response, a number of rules have developed that make it more difficult for defendants to evade liability for losses flowing from their reckless or fraudulent conduct. For example, the test for causation is not as strict for fraudulent misrepresentation as it is for negligence; it is sufficient for the former if the deceit is a substantial cause of the loss (see *Smith New Court Securities Ltd v Citibank NA* [1997]). It was also held by the House of Lords in *Smith New Court* that, unlike other torts and breach of contract, damages in cases of deceit can be recovered for loss that is unforeseeable and outside the contemplation of the parties. Similarly, it was confirmed by the House of Lords in *Standard Chartered Bank v Pakistan National Shipping Corporation (Nos 2 and 4)* [2003] that, unlike the tort of negligence, contributory negligence was not a defence to an action based on fraudulent misrepresentation.

Furthermore, following the collapse of the Equitable Life and BCCI cases in 2006, the Commercial Court Users Committee set up a working party in January 2007 with the objective of streamlining heavy and complex litigation in the Commercial Court. The working party delivered its report in December 2007 and its proposals and recommendations are currently being implemented in the Commercial Court for a trial period extending to 31 July 2008.

A full study of that report is outside the scope of this briefing, but certain recommendations are illustrative of the nature of the Committee's proposals. For example, it is recommended that statements of case should not set out detailed background facts and evidence together with law and argument. They should normally be limited to no more than 25 pages in length and should identify the key aspects of the case. In addition, at the first case-management conference, the court should settle a list of key issues from a draft provided by the parties. This will be a court document and will regulate the scope of subsequent witness statements and disclosure. For trial, it was recommended that opening speeches for two-party cases should ordinarily be no more than two days in length and time limits should be set for the examination of witnesses.

If successful, these recommendations may be implemented in other divisions of the English court and may be applied to all commercial litigation (and not only heavy and complex cases). It remains to be seen how these proposals will interact with fraud claims, given the English courts' traditional requirement for allegations of dishonesty to be pleaded in full. However, the implementation of the recommendations may make the prosecution of fraudulent directors a more attractive and efficient option for those acting on behalf of claimant companies.

CONCLUSION

For companies in financial difficulty, fraud-based litigation can be a difficult and expensive undertaking and careful consideration will need to be given to questions of solvency, funding and the preservation and collation of relevant information and documents. Nevertheless, there have been a number of legal developments that have sought to make the process more accessible and in the appropriate circumstances the prosecution of unscrupulous directors can be an effective means of recovering assets for the benefit of the company and its creditors.

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