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Misfeasance Actions Against Directors of Insolvent Companies

Seminar for Academy of Law

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Topics covered

1. A brief discussion on different types of “misfeasance claims”
2. More in-depth discussion on “the duty to act bona fide in the best interest of the company”
3. Can director be liable for “unfair preference” outside the statutory regime?
4. The Increase in Net Deficiency claim – IND and Wrongful/Insolvent Trading
5. Fraudulent Trading claim
6. Discretionary relief
7. TIME BAR and the “NCHK Principle”

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Part 1 What's a "misfeasance claim"?

"Misfeasance claim" is a generic term referring to claims against former directors or officers of a wound-up company for breach of any legal duties.

In the words of s.276 of the CWUMPO, Cap 32:-

If in the course of winding up a company it appears that **any person** who has taken part in the formation or promotion of the company, **or any past or present officer or liquidator or receiver of the company**, has misapplied or retained or become liable or accountable for any money or property of the company, or been **guilty of any misfeasance or breach of duty in relation to the company which is actionable at the suit of the company**, the court may, on the application of the Official Receiver, or of the liquidator, or of any creditor or contributory, examine into the conduct of the promoter, officer, liquidator or receiver, and compel him to repay or restore the money or property or any part thereof respectively with interest at such rate as the court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance, or breach of trust as the court thinks just.

Part 1 What's a "misfeasance claim"?

It is well recognized that s.276 does not create any new or separate basis of liability of directors [e.g. Re B Johnson & Co (Builders) Ltd [1955] Ch 634]

It is only a procedural device for liquidators (as well as creditors and contributories) to enforce existing rights of the company in a summary manner.

"Misfeasance" and "breach of duty" are hardly distinguishable and they cover all misconducts referred to in s.276 ("misapplication", "retainer", "breach of trust").

For convenience, "Misfeasance" is used to encompass all these terms and all claims under s.276.

Part 1 What's a "misfeasance claim"?

A director's duties to the company are classified into two broad categories:-

- Fiduciary duties
- Duty of care [D'Jan of London; Weavering Capital]

Fiduciary duties are further sub-divided into:-

- Proscriptive = duty to avoid conflicts, not to gain personal profits from his position as director [Regal (Hastings) [1942] ALL ER 378; Tradepower FACV 5/2009]
- Prescriptive (or Non-Proscriptive) = to act bona fide in the best interest of the company [Colin Gwyer; Moulin]

Prescriptive Fiduciary Duty – broadest application, most controversial, especially when applied in the insolvency situation

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Part 2 The Prescriptive Fiduciary Duty

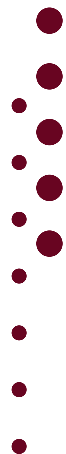
These duties have been codified in the UK Companies Act 2006 (s.172) and also the HK Companies Ordinance (s.465, Cap 622).

Regarding the Prescriptive Fiduciary Duty whilst the company is insolvent, s.172(3) of the UK Act expressly provides that:-

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole …

(2) …

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act **in the interests of creditors** of the company.



Part 2 The Prescriptive Fiduciary Duty

The courts in England do not generally regard s.172(3) to have created any new law but rather a recognition of the principles developed in the long line of cases starting from in a long line of cases starting from Kinsela v Russell Kinsela Pty Ltd (1986) 10 ACLR 395 and West Mercia Safetywear Ltd v Dodd [1988] BCLC 250 that directors have to take into account creditors' interest when the company is insolvent or close to it. The HK situation should be no difference even though the wording is not the same.

How is the duty to creditors applied?

Part 2 The Prescriptive Fiduciary Duty

Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd [2003] BCC 885 (at para 87):-

> 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….

*Charterbridge Corporation Ltd v Lloyd's Bank Ltd [1970] Ch 32

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Part 2 The Prescriptive Fiduciary Duty

The Charterbridge Corporation case endorsed the principle in Re Smith & Fawcett [1942] Ch 304 and extended it as follows:-

1. The test for determining whether directors acted properly was: did they believe (subjectively) that what they did was in the best interests of the company?
2. If the answer to (1) is yes, the director has fulfilled his duty. If no, he breached his duty. [Re Smith & Fawcett]
3. If the director has not given any thought as to whether the act complained of would be in the interests of the company, objective considerations come into play and the court had to ask whether an intelligent and honest man in the position of the director could, in the whole of the circumstances, have reasonably believed that the action was for the benefit of the company [Charterbridge Corporation]

Hence, it's WRONG to say that misfeasance claim does not need to consider the subjective mental state of the directors.

Part 2 The Prescriptive Fiduciary Duty

An alternative formulation to establish breach of the prescriptive fiduciary duty is set out by Jonathan Parker J in Regentcrest plc (in liq.) v Cohen [2001] B.C.C. 494 at [para 123]:

> "… where a power conferred on a director is used for a collateral purpose … it matters not whether the director honestly believed that in exercising the power as he did he was acting in the interests of the company; the power having been exercised for an improper purpose, its exercise will be liable to be set aside (see, e.g., Hogg v. Cramphorn Ltd [1967] Ch 254).…"

Hence, if it could be established that the power was used by the director for a collateral purpose other than promoting the interest of the company (e.g., employing one's girlfriend instead of a much more competent candidate), it is not necessary to consider whether the director honestly believed that his decision is in the best interest of the company.

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Part 3 Liability for "unfair preference" outside statute?

The Colin Gwyer principle was recently applied by the HK CFA in the striking out application of:-

Moulin Global Eyecare v. Olivia Lee (2014) 17 HKCFAR 466

At issue is: whether Ms. Lee, a former director, in procuring the company to make repayment on certain convertible notes when (she ought to have known) the company was insolvent had acted in breach of her fiduciary duties.

Both CFI [HCA 167/2008 (Decision 27 June 2012)] and CA [CACV 155/2012 (Decision 7 December 2012)] struck out the claim by the liquidators on the ground that the repayments were discharge of genuine liabilities and hence there was **no loss** caused to the company.

Part 3 Liability for "unfair preference" outside statute?

However, the CFA held that, even though in one sense the company suffered no loss, the claim was maintainable if framed as a claim for breach of the **prescriptive fiduciary duty**. The CFA accepted the following propositions put forward by counsel for the liquidators:-

1. A director owes a duty to act bona fide in the best interests of the company.
2. In an insolvency context the duty requires the director to take into account the interests of creditors.
3. The duty may extend to not prejudicing the interests of creditors and preserving the assets of the company so that those assets may be dealt with in accordance with ordinary principles of insolvency law, including the fundamental principle of pari passu distribution of the company's assets amongst all creditors.
4. A director who **knowingly** causes a company to pay away company assets to a creditor (and who thereby dissipates those assets so that they are not available for pari passu distribution to all creditors) **when he does not subjectively believe that the payment is in the best interests of the company may act in breach of duty**. [emphasis added]

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Part 3 Liability for "unfair preference" outside statute?

Note the required elements to establish liability in proposition 4 – very subjective.

The CFA still regarded the pleadings in respect of the Convertible Notes Claim as "embarrassing" (para 65) and further amendments would be required. It was allowed to stay only because such claim was held to be, in principle, capable of falling within the purview of the general indorsement of claim filed by the liquidators, which claimed:-

> "…equitable compensation in respect of loss and damage suffered by the Plaintiff … as a result of **breaches of fiduciary… duties** and/or breaches of the duty of care and skill owed by the Defendant…arising out of her role as director or employee of the Plaintiff" in the course of the preparation, auditing and certification of the Moulin accounts, the discharge by the defendant of her duties as a member of Moulin's Audit Committee, and the provision by the defendant of professional advice and services to Moulin."

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Part 3 Liability for “unfair preference” outside statute?

The CFA held that the words “fiduciary duties” as appearing in the indorsement of claim should be read in the broad sense:-

35. However, in the indorsement the term “fiduciary” is used not in its strict sense, but more broadly to encompass the established or asserted equitable duties of a director to act bona fide in the interests of Moulin as a whole, to act fairly between different shareholders, and to consider the interests of creditors if Moulin be insolvent or of doubtful solvency.

Part 3 Liability for “unfair preference” outside statute?

One might ask, were the CFI and CA wrong? Though the claim was maintainable in principle as a breach of duty claim, what’s the loss to the company? And how should the director compensate it (assuming liability could be established)?

First, the CFA seems to have also accepted the following propositions put forward by the liquidators in Moulin:-

5.The company may pursue equitable remedies (such as equitable compensation) against the director to restore the company to the position that it was in prior to the breach of duty.

6.The assets restored to the company are then available for pari passu distribution amongst all creditors.

7.Equitable remedies are discretionary. The court has power to mould relief depending on the nature and facts and circumstances of the individual case. As a result, orders can be made to ensure that the company and the general body of creditors are not over-compensated.

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Part 3 Liability for "unfair preference" outside statute?

An actual example of the applications of these proposition is afforded by the case Hellard v Carvalho [2013] EWHC 2876 (decided after the CA decision in Moulin but before the CFA hearing).

- Director of an insolvent company chose which creditors to pay and which to leave exposed to the real risk of being unpaid. The payments included repayment of debts owed to his father, payments made to himself and to companies personally controlled by him and Christmas bonuses made to a key employee.
- Some of these payments were discharging genuine liabilities of the company yet the court held that the director was in breach of his fiduciary duty in making those payments.
- As there's no evidence that the director had actually considered the interest of the company (creditors in general) in making those payments, the court applied the objective test (applying Colin Gwyer) and found that an intelligent and honest man in the position of the director couldn't have reasonably believed that the payments were for the company's benefit.

Part 3 Liability for “unfair preference” outside statute?

The argument of “no loss” was rejected by the judge in Hellard, whom the CFA seems to have agreed (para 55):-

> “… It is apparent from the reasons of the Deputy Judge [in Hellard] that he regarded the relevant prejudice or “loss” to the company as assessed not by reference to the state of the balance sheet at the time of the payment, albeit this was the time when the breach of equitable duty occurred, but at the time of the insolvent administration by the liquidators….”

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Part 3 Liability for "unfair preference" outside statute?

With respect to payments that discharged a genuine liability to a creditor (NordLB), the order made against the director in Hellard was in this form:-

> The Respondent do pay £1,557,907 to the Company PROVIDED THAT it is directed that in the distribution of the assets of the Company to unsecured creditors, the debt due from the Company to NordLB is to be taken as notionally increased by £1,557,907 to what it would have been if the NordLB Payments had not been made, and then any dividend attributable to the extra sum thus added back to the debt of NordLB is to be recouped to the Respondent rather than being paid to NordLB …..

That means if, say, the Company can pay 10 cents in a dollar, the Respondent would get a 10% discount on his liability to compensate the Company (i.e., 10% of £1,557,907 in this case)

Part 3 Liability for “unfair preference” outside statute?

So, it is now clear that payment to discharge **genuine** liability of a company when it is insolvent (or close) could still result in liability to the director if it is established that in doing so the director had not acted in good faith in the best interests of the company.

However, the question of quantum can become very complicated if the early repayment claim is entangled with other claims by the liquidators, as the CFA acknowledged (para 65).

Hence, an alternative claim in IND was put forward.

Part 4 The IND Claim

A controversial use of misfeasance claim: the IND claim – Increase in Net Deficiency

In Moulin, four years after the writ was issued, the liquidators added this to the claims against Ms Lee as an alternative:-

> Further and in the alternative … the [Company] suffered loss of at least HK$1.23 billion constituting the increase in the net deficiency of the [Company] from at least 31 March 2001 until the date of appointment of the Provisional Liquidators on 23 June 2005, an increase from a net deficiency of HK$745 million had Provisional Liquidators been appointed as at 31 March 2001 to the actual net deficiency in the winding up of the [Company] of HK$1.98 billion.
>
> i.e., HK$ 1.98 billion – 745 million = HK$ 1.23 billion

Part 4 The IND Claim

The IND claim is premised upon the following:-

1. By 31 March 2001 the latest, the Director knew or ought to have known, that the Company was insolvent and there's no hope to trade out of insolvency;
2. She should have procured the appointment of PL (or otherwise blown the whistle);
3. Instead she let the Company trade on and as a result there was an IND of HK$1.23 billion by the time the Company was wound-up.

Part 4 The IND Claim

Such a misfeasance claim is premised upon a breach of the “duty of care and skill”, i.e., negligence, not “fiduciary”.

The essential allegations are as follows:-

1. The Company was insolvent before Date 1 and there was no hope to trade out of insolvency;
2. The Director knew or ought to have known by Date 1 of this fact and taken appropriate action to stop the Company from trading;
3. As a result there was an IND from Date 1 to Date 2 (when PL or L was appointed);
4. Because of (2) the Director was in breach of the duty of care, i.e., negligence
5. Hence, she should compensate the Company for the IND

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Part 4 The IND Claim

The IND claim was very similar to the “wrongful trading” claim under s 214 of the UK Insolvency Act 1986 (which in turn is very similar to the “insolvent trading” claim proposed to be enacted in HK)

The material parts of s. 214 provides as follows:-

(1)…. if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company’s assets as the court thinks proper.

(2)This subsection applies in relation to a person if—

a) the company has gone into insolvent liquidation,
b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
c) that person was a director of the company at that time;

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Part 4 The IND Claim

(4) …. the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—

a. the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
b. the general knowledge, skill and experience that that director has.

Part 4 The IND Claim

Although HK does not have insolvent/wrongful trading provisions (yet), the viability (in principle) of an IND claim in HK was endorsed by the CFI, CA and CFA in the Moulin case (in interlocutories).

In UK, in most cases of “wrongful trading”, “misfeasance” was claimed as an alternative (negligence in failing detect problems and/or to put the company into liquidation). In practice, they always stand and fall together.

e.g., Re DKG Contractors Ltd [1990] B.C.C. 903 (both claims succeeded)

Re The Continental Assurance Company of London plc [2001] BPIR 733; (both claims failed)

Rubin v Gunner [2004] EWHC 316 (both claims failed)

Roberts v Frohlich [2012] B.C.C. 407 (both claims succeeded)

Re Idessa (UK) Ltd (In Liquidation) [2012] B.C.C. 315 (both claims succeeded)

Of course, directors may be liable for specific instances of misfeasance without being liable for wrongful trading, e.g.: Re Marini Limited [2003] EWHC 334:

Wrongful trading claim failed as L failed to prove that directors “should have known” of the insolvency but directors still liable for wrongful payment of dividends

Part 4 The IND Claim

Although the words “negligence” or “standard of care” were not used in the wrongful/insolvent trading provisions, it is hard to find a case where a director “knew” or “ought to have known” of the inevitable liquidation of the company and carried on trading without being “negligent”.

Note that the same hybrid “objective/subjective” test for wrongful trading (s.214(4) Insolvency Act 1986) was used for knowledge in the wrongful/insolvent trading provisions as directors’ duty to exercise reasonable care, skill and diligence (s.465 (2), Companies Ordinance, Cap 622).

Part 4 The IND Claim

The starting point for measure of liability under wrongful/insolvent trading claim is IND, and the court has **discretion** in assessing the contribution to be made by the director found guilty of wrongful/insolvent trading. (see subsection (1) of s.214 of the Insolvency Act 1986)

However, there's a very important difference between wrongful trading claim and a misfeasance claim for IND: - CAUSATION.

Part 4 The IND Claim

In Re The Continental Assurance Company of London plc [2001] BPIR 733;

The Ls alleged that as a result of the directors' misfeasance (negligence), the company continued to trade after Date 1, and IND of £3.6m was incurred when the company eventually commenced winding-up.

Such claim was rejected (amongst other reasons) for having adopted a wrong test for causation.

Part 4 The IND Claim

Park LJ said (at para 406):-

"The courts do not adopt a 'but for' test of causation. I agree with counsel for the respondents that this is clearly laid down, in a similar context, by the decision of the Court of Appeal in Galoo Ltd v Bright Grahame Murray [1995] 1 All ER 16 . The plaintiffs' case was that a company's auditors, negligently and in breach of duty, prepared accounts which did not accurately reflect the company's true financial position. If the accounts had been properly prepared they would have shown that the company was in such an unsatisfactory financial condition that it would have ceased trading immediately. In fact, given the negligently prepared accounts, the company carried on trading and sustained losses in doing so. It sought to recover the losses from the auditors. The Court of Appeal held that the alleged breach of duty did not cause the losses. The losses were trading losses, and were not caused by the auditors' negligence. The losses could only be regarded as having been so caused on the basis of a **'but for' test** of causation, but **that was not the test which English law applied**. The auditors' breach of duty did not cause the trading losses. Rather, as Glidewell LJ put it, it 'gave the opportunity' to the company to incur them…."

Part 4 The IND Claim

This issue has not been discussed in any length in any of the Moulin decisions (probably because they were all only interlocutories).

The **Galoo** case has caused some controversies and this is an exceedingly complicated area of law (causation, also the issue of foreseeability). Suffice to say an IND claim at common law is far from straightforward.

The important difference between a misfeasance claim for IND and a wrongful trading claim is that **wrongful trading claim is based on statute** (s.214 Insolvency Act 1986) whereas **misfeasance is a common law claim**.

Part 4 The IND Claim

Under s.214(1), the court has **statutory power** to order contribution on a discretionary basis. But under common law, causation must be established.

In Re Brian D Pierson (Contractors) Ltd [1999] BCC 26, the court discounted 30% off the IND as the director's contribution as it was held that the IND was in part due to extraneous factors, such as bad weather conditions. It is doubtful if the court could do that under a common law misfeasance claim.

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Part 5 Fraudulent Trading claim

The relationship and differences between the court's statutory power and common law Misfeasance claim is also important in the context of Fraudulent Trading claim (s.275, CWUMPO).

s.275 CWUMPO provides:-

(1) If in the course of the winding up of a company it appears that **any business of the company has been carried on with intent to defraud creditors** of the company or creditors of any other person **or for any fraudulent purpose**, the court, on the application of the Official Receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that **any persons who were knowingly parties to the carrying on of the business** in manner aforesaid shall **be personally responsible**, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

Part 5 Fraudulent Trading claim

Fraudulent trading claim has always been castigated as rather useless as the liquidator/creditor has to prove ‘subjective dishonesty’ and ADS v Brothers FACV 25/1998 is often cited as example.

Mr. Brothers procured ADS to extend credit to Wheelock Maritime International (WMI). WMI subsequently went into liquidation without repaying ADS. The central issue in the case is whether the director (Mr. Brothers) genuinely believed that the company’s parent Wheelock Marten (WM) would continue to provide financial support (so as to avert the liquidation of WMI). At trial, the judge found in favour of Mr. Brothers on the following grounds (para 5.7.46):-

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Part 5 Fraudulent Trading claim

(1) Until a very late stage there was no clear and unequivocal signal given by WM that there would be no more support.

(2) The provision of drip feed from time to time … rather indicated that WM remained committed to the principle of support.

(3) From very early on, WMI and its directors were receiving financial and legal advice. "It is inherently unlikely that Mr. Brothers or any other director would have embarked on a course of fraud with the advisers looking over their shoulders."

(4) "…the minutes and documents I have reviewed generally indicate an expectation that there would be a future."

(5) "It is axiomatic that a parent should support a subsidiary. Rothschilds [the financial adviser] emphasised this...." Mr. Brothers … was entitled to derive comfort from this, particularly in the light of Mr. Marden's interest in shipping and WM's strong reputation.

(6) "[Mr. Brothers] derived no personal benefits from keeping WMI going, other than the satisfaction of a job well done…. "

(7) "My very carefully considered appraisal is that [Mr. Brothers] was for the most part a sincere and honest witness…."

Part 5 Fraudulent Trading claim

In CFA, Lord Hoffmann, NPJ, also commented that:-

"In my opinion none of the matters relied upon [by ADS's counsel] was inconsistent with the judge's finding or, I would say, sufficient to overcome **the overwhelming improbability that the directors were conducting a fraud in the broad light of day**…."

Part 5 Fraudulent Trading claim

Would the case against Mr. Brothers be made easier if it is framed as a "misfeasance claim"?

Possibly, but very doubtful.

In a misfeasance claim, the standard may be lower – that of negligence or acting for improper purpose. But in light of the facts found in favour of Mr. Brothers, could he be said to be negligent or not acting for a proper purpose?

Part 5 Fraudulent Trading claim

In fact, whilst most commentators discussed ADS as a ‘fraudulent trading” case, **the ADS case is also a “misfeasance” case**. (See section 5.15 of the CFI judgement):-

5.15.1 Should its primary case on fraudulent trading fail, ADS pleaded an alternative in paragraphs 29 and 30 ASOC

“29. Further and/or alternatively, at all material times, albeit that the Defendants knew or **ought to have known** or were acting recklessly as aforesaid, the Defendants failed to inform the Plaintiff of the true position which, if known would have caused and/or enabled the Plaintiff to cover its position. Further and/or alternatively **the Defendants failed to put WMI into liquidation thereby allowing its assets to be dissipated**….

[an IND claim?]

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Part 5 Fraudulent Trading claim

> *30. Further and/or alternatively, to the extent that it was the case or can be inferred from all the aforesaid that **the Defendants were acting contrary to the interests of the Plaintiff and/or the Creditors generally and/or were acting in their own interests and not those of WMI** (whether to try and protect their position on a charge of fraudulent trading, or to protect their position financially or otherwise) **such were improper purposes** within the Companies Ordinance...."*

Authorities like Kinsela and West Mercia were cited to the judge. But Barnett J still found that on the facts, this alternative case was not made out. (Note that actually ADS may not be the right party to make such a claim. But Barnett J did reject the claim not on this ground.)

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Part 5 Fraudulent Trading claim

In Rubin v Gunner [2004] EWHC 316, a case for wrongful trading and misfeasance, the directors/shareholders set up an entertainment management company. It was not making much profits but a flamboyant investor (Mr. Stables) kept on promising to inject funds and drip-feeding the company.

The judge found that:-

- Although the company was insolvent on Date 1, the Respondents had a genuine and reasonable belief that Mr Stables would provide sufficient funding for the company to avoid the company going into insolvent liquidation;
- The Respondents' belief was further justified by the impression which they reasonably had that Mr Stables was a person of considerable substance and had access to very substantial funds;
- The Respondents' actions were under advice of a chartered accountant.

The misfeasance claim was dismissed.

Part 5 Fraudulent Trading claim

It can be seen that in cases where the directors reasonably relied on expert financial and/or legal advice, it would be difficult to hold them liable for misfeasance/fraudulent trading, as illustrated by **ADS**, **Rubin v Gunner**, and **Continental Assurance.**

The claims in **ADS** failed not because s.275 is overly stringent, but because the facts of the case did not support even a misfeasance claim against Mr. Brothers, not to say "a fraud in the broad light of day".

Part 5 Fraudulent Trading claim

Fraudulent remains very useful.

In fact, before and after ADS, there has been a number of successful use of the Fraudulent Trading provision in UK (though it seems not in HK), both in civil claims as well as criminal prosecutions, e.g.:-

Re Esal (Commodities) Ltd [1997] 1 BCLC 705

Morris v Bank of America National Trust and Savings Association [2000] BPIR 83

Morris v Bank of India [2005] 2 BCLC 328

And most recently:-

Jetivia SA & Anor v Bilta (UK) Ltd & Ors [2015] UKSC 23 (**22 April 2015**)

Part 5 Fraudulent Trading claim

Jetivia SA & Anor v Bilta (UK) Ltd & Ors [2015] UKSC 23 (22 April 2015)

•Bilta entered into carbon emission quota trading with Swiss company Jetivia.

•Through a fraudulent scheme Bilta obtained VAT credits from HMRC iro the purchase from Jetivia but defrauded on its VAT obligations in its sale of the quota to UK companies.

•HMRC sued the directors of Bilta (for fraudulent trading), the CEO of Jetivia and Jetivia (for knowingly a party to fraudulent trading).

•The Supreme Court found them all liable.

•The Supreme Court also found that the fraudulent trading provision has extraterritorial reach to bring Jetivia within the jurisdiction.

Part 5 Fraudulent Trading claim

Similarly in Morris v Bank of India [2005] 2 BCLC 328, BOI was held liable to contribute to the IND of BCCI because it participated in a fraudulent scheme to cover up the bad loans of BCCI thus prolonging its natural life. [causation issue?]

Even less expected in Re Gerald Cooper Chemicals Limited (in Liquidation) [1978] 1Ch 262, it was a creditor who was found liable. The respondent creditor allegedly had accepted as part repayment of a debt owing by the insolvent companies money which he knew had been obtained by fraud on another creditor.

Templeman J said :

"In my judgment, a creditor is party to the carrying on of a business with intent to defraud creditors if he accepts money which he knows full well has in fact been procured by carrying on the business with intent to defraud creditors for the very purpose of making the payment…."

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Part 5 Fraudulent Trading claim

In Re Augustus Barnett & Son Limited [1986] BCLC 170, Hoffmann J said :

"The words 'persons ... parties to' may be wide enough to cover outsiders who could not be said to have carried on or even assisted the carrying on of the company's business, but who nevertheless in some way participated in the fraudulent acts. For an example see Re Gerald Cooper Chemicals Limited…"

Part 6 Discretionary Relief

Defence – Discretionary relief under s. 903, 904 Cap 622

(1) This section applies if, in any proceedings for any misconduct against a specified person, it appears to the Court that the person—

  (a) is or may be liable for the misconduct;

  (b) has acted honestly and reasonably; and

  (c) ought fairly to be excused for the misconduct, having regard to all the circumstances of the case (including those connected with the person's appointment).

Part 6 Discretionary Relief

Application for relief is rarely successful. Some examples of success:-

Re D'Jan of London Ltd [1993] BCC 646

- Director, having delegated the task to his broker, answered a questionnaire for an insurance policy wrongly.
- Insurance policy avoided. Director held liable for negligence.
- Relief granted by taking into account the following factors:-
    - Director was 99% shareholder
    - At the time the mistake was made, the company was solvent
    - It's not 'gross' negligence to have delegated the task.

Re Simmon Box (Diamonds) Ltd [2000] BCC 275

- Director was 20 years old son of the owner of the company
- Did not actually participate in the business of the company
- Reposed too much trust on father who's outwardly successful
- Liability partially relieved.

Part 7 Time Bar and the NCHK Principle

Case Study

- *The New China Hong Kong Group Ltd v Ernst & Young + Anthony Wu* HCCL 41/2004 (facts presented below are simplified version)

  - NCHK – founded by TTT, incorporated in 1992, went into CVL in 1999.
  - L investigated and fought a number of s.221 CWUMPO summonses with EY and AW
  - Actions commenced against EY in 2004 and AW in 2005 (the case was heard in 2008)
  - EY was auditors for whole period, also financial adviser. AW was lead partner.
  - AW was director up to 1993, then financial adviser on the executive committee.
  - Claims against EY – iro 94, 95 audited accounts, EY gave unqualified opinions (in 95 and 96) and failed to give warning of over-exposure to 7 dubious debtors.

When did cause of action accrue?

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Part 7 Time Bar and the NCHK Principle

When did cause of action accrue?

L: when the NCHK went into liquidation.

EY: when the audited reports were issued.

Answer: ?

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When did time start to run for contract claim? for tort claim?

What's the loss caused by the negligent audit?

- The full amount of the loans?
- No, it's just the chance to salvage what's left of the bad loans (by realising securities and enforcing the loan).
- Hence, cause of action accrued shortly after the issuance of the audited reports when management was supposed to take necessary action if the audited reports had not been negligently prepared and had given the necessary warnings.
- Note: cause of action in torts is completed when damage is suffered.

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Hence, primary limitation of 6 years has passed.

What about secondary limitations under s.31 LO?

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s.31, LO

(1) This section applies to any action for damages for negligence, other than one to which section 27 applies, where the earliest date on which the plaintiff or any person in whom the cause of action was vested before him first had both-

(a) **the knowledge required for bringing an action for damages in respect of the relevant damage**; and

(b) a right to bring such an action, ...

(4) That period is either-

(a) 6 years from the date on which the cause of action accrued; or

(b) **3 years from the date of knowledge**, if that period expires later than the period mentioned in paragraph (a).

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s.31, LO

(5) In subsection (1) "the knowledge required for bringing an action for damages in respect of the relevant damage" means knowledge-

- (a) of such facts about the damage in respect of which damages are claimed as would lead a reasonable person who had suffered such damage to consider it sufficiently serious to justify his instituting proceedings for damages against a defendant who did not dispute liability and was able to satisfy a judgment;
- (b) that the damage was attributable in whole or in part to the act or omission which is alleged to constitute negligence;
- (c) of the identity of the defendant; and
- (d) if it is alleged that the act or omission was that of a person other than the defendant, of the identity of that person and the additional facts supporting the bringing of an action against the defendant.

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s.31, LO

(6) Knowledge that any acts or omissions did or did not, as a matter of law, involve negligence is irrelevant for the purposes of subsection (1).

(7) For the purposes of this section or section 33 a person's knowledge includes knowledge which he might reasonably have been expected to acquire-

(a) from facts observable or ascertainable by him; or

(b) from facts ascertainable by him with the help of appropriate expert advice which it is reasonable for him to seek,

but a person shall not be taken by virtue of this subsection or section 33 to have knowledge of a fact ascertainable only with the help of expert advice so long as he has taken all reasonable steps to obtain (and, where appropriate, to act on) that advice.

Part 7 Time Bar and the NCHK Principle

s.31, LO

Key issues:-

- only applies to negligence, not contract
- “the knowledge required for bringing an action for **damages** in respect of the relevant **damage**” – what does it mean?
- whose knowledge?

Part 7 Time Bar and the NCHK Principle

Kensland Realty Ltd v. Tai, Tang Chong [2008] HKCFA 13

- A few months before the NCHK case, these questions have been authoritatively answered in *Kensland Realty Ltd*.
- Kensland sold a property to purchaser to be completed on 2 September 1997.
- On the completion date (2 September 1997), it (through TTC) only gave instructions on split cheques to purchaser's solicitors in less than 2 hours.
- Purchaser was 6 minutes late to deliver cheques (1:06 pm).
- Kensland, on advice on its legal adviser, TTC, treated this as repudiation, forfeited the deposit and refused to complete.
- Purchaser immediately sued Kensland on 3 September 1997.

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Kensland Realty Ltd v. Tai, Tang Chong (cont'd)

- Kensland won against purchaser at First Instance (5/4/2000) but lost in CA (23/1/2001) and lost again in CFA (10/12/2001)
- Kensland sued TTC in 2004.
- When would it be deemed to have "the knowledge required" to bring an action against TTC for negligent advice?

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- **Answer: 3 September 1997 !**

Why? Because of s.31(5) and (7) LO

- What is required is the knowledge of “damage”, NOT legal knowledge of “liability” or “cause of action”.

Part 7 Time Bar and the NCHK Principle

The New China Hong Kong Group Ltd v Ernst & Young (the "NCHK case")

- The Court summarised the principles in Kensland as follows:-

(1) The knowledge which sets time running under s. 31 LO consists both of the plaintiff's actual knowledge and knowledge which is imputed to him (para. 68);

(2) S. 31 is concerned with the plaintiff's knowledge relating to the **damage** incurred and not with the defendant's liability. The section has nothing to do with whether the plaintiff knew that the defendant's conduct amounted in law to negligence or that he had a good claim against the defendant (paras. 73, 74);

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The NCHK case (cont'd)

(3) S. 31(5)(a) LO establishes a low threshold. The knowledge required to set time running is likely to be satisfied where a plaintiff becomes aware of **some** actual damage, provided that it is not so trivial as to be not worth bothering about (para. 79);

(4) S. 31 LO does not require the plaintiff to have detailed knowledge of all the acts and omissions set out in the particulars of his pleadings as constituting negligence. What matters is the plaintiff's knowledge of what lies at the core of the pleaded case. The requisite knowledge is not of the acts or omissions as pleaded but knowledge of the facts constituting "the essence of the complaint of negligence" distilled from such pleading (paras. 103, 105);

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The NCHK case (cont'd)

(5) Knowledge of the "essence" of the act or omission is gained "the moment at which the plaintiff knows enough to make it reasonable for him to begin to investigate whether or not he has a case against the defendant": Hoffmann LJ in *Broadley v. Guy Clapham & Co.* (para. 107);

(6) The plaintiff must be shown to have actual or imputed knowledge of all the facts which are essential to the complaint which is eventually formulated as his negligence claim (para. 108).

Part 7 Time Bar and the NCHK Principle

s.31, LO (cont'd)

- Hence, it could be seen that the threshold is rather low. Further, the burden is on the plaintiff to prove that he did not have such knowledge. It seems the law imposes an obligation on the claimant to start investigating, getting advice and formulating the claim from the time of knowledge of the **damage. And he's given 3 years.**

- In the NCHK case, the plaintiff argued that it was only after the s.221 CWUMPO proceedings, which took a few years to conclude, and after full analysis of the transcripts, that the full extent of EY and AW's breaches of duty have become clear.

- However, the court found that whilst the s.221 CWUMPO transcripts may provide further evidence to support the claims, the essence of the claims was known long before that.

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Known by whom?

- Note that the plaintiff in the NCHK case is the company acting through the liquidators, **NOT the liquidators**.
- Hence, it's the knowledge of the company that counts, NOT the liquidators'.
- What's meant by the knowledge of the company?
- Rules of attribution: knowledge of the defendants and those (within the company) who conspire with him doesn't count
- Knowledge of directors who are in a position to act would count.

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The NCHK case (cont'd)

- The court held that the essential facts in this case are that:-
  - NCHK's business was conducted in a reckless manner and that the defendants failed to give the necessary warning and signed unqualified opinions of its audited accounts.
- It was found that the finance director and some other directors were aware of these facts well before the winding up of NCHK in 1999. It was not pleaded and no evidence was presented that they were in any way connected with the alleged negligent acts of EY and AW.
- Hence, NCHK and the liquidators, when they took over, were fixed with the knowledge of the essential facts through these directors.

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This is a well-established position in law. A similar defence tactics was successfully deployed in the more recent case of **Dryburgh v Scotts Media Tax Limited** [2011] CSOH 147

Can the liquidators of NCHK sue those ‘independent directors’ who had knowledge but failed to act?

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In fact, it is now well accepted that issuance of writ is no bar to continuing s.221 application:-

In Re B+B Construction Company Limited CACV 196/2004, the CA held:-

- s.221 order could be made even after a writ was issued, particularly when it is clear that there were still matters that required investigation and that the writ was merely issued for time bar consideration.
- The fact that a writ has been issued is no answer for a respondent to refuse to comply with a demand made pursuant to s.221.

So, liquidators should not wait for finalisation of s.221 proceedings (it could take years!). Issue a generally endorsed writ like the one in **Moulin**.

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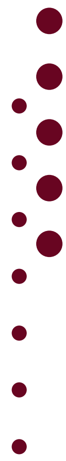
Final thoughts

- Directors of insolvency company face high risk of being sued for breach of duties
- To alleviate such risk, directors must:-
  - Be watchful over the company's solvency situation;
  - Seek professional help from expert insolvency practitioners;
  - Document rationales for decisions;
  - Avoid preferring any creditors even if such preference is outside the statutory regime;
  - Stop trading/commence winding-up if necessary
- Major defences:
  - No breach (drag in the auditors)
  - Causation
  - Time bar



Thank you!

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Primerus Member

Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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