

Introduction

The general rule is that no-one is liable for the debts of a company except the company itself. The shareholders of the company are not liable for its debts, except where their shares are partly paid, and then only to the extent of the unpaid amount. Likewise, the directors are not usually liable. Companies were invented to provide a facility for business to be carried on whilst limiting the liability of those involved with it. The provisions of Guernsey law in relation to fraudulent and wrongful trading create an exception to this general rule by providing, in some circumstances, for those involved in the management of a company to be personally liable for its debts. These provisions are contained in sections 433 and 434 of the Companies (Guernsey) Law, 2008, having been inserted into the former 1994 Law by the Companies (Amendment) (Guernsey) Law, 1996,

These provisions were introduced as a result of a perception on the part of certain politicians that the limited liability associated with carrying on business through a company was being used by some people unfairly to the detriment of creditors. For example, there were a number of occasions when the owners of companies with substantial debts simply put those companies into liquidation and incorporated new companies, often with very similar names to the original companies, and carrying on identical businesses to the original companies, leaving the creditors of the original companies with little or no recourse.

The provisions in relation to fraudulent and wrongful trading were based on parallel provisions of English law, which is useful to the extent that it means that we have judgments of English Courts in relation to the English provisions which can be used in the interpretation of the Guernsey provisions.

Before dealing separately with wrongful trading and fraudulent trading, it is appropriate to note a number of points which are common to both:

1. In order for the fraudulent and wrongful trading provisions to apply, the relevant company must be in liquidation. By no means all Guernsey companies which are insolvent are liquidated. In many cases, particularly those involving companies trading locally, the “desastre” procedure, which is simpler and cheaper, is used. This procedure involves Her Majesty's Sheriff, an officer of Guernsey's Royal Court, arresting and selling the assets of an insolvent company (or individual) and distributing the proceeds to the creditors. If there is a shortfall a “desastre” is declared and the creditors receive a dividend out of the proceeds held by H.M. Sheriff. It would be extremely unusual for H.M. Sheriff to concern himself with the manner in which an insolvent company has been operated before becoming insolvent; indeed he is not in a position to do anything about them himself, nor to apply to the Court for the appointment of a liquidator even if he is suspicious, for

example, that the company has been milked dry to the detriment of its creditors. He could, however, pass his suspicion on to one or more of the creditors, and it is always open to any creditor of a company who is owed £750 or more by the company to put the company into liquidation, even where the company has already been declared “en desastre”. However, there have been many cases

where creditors have been unwilling to put a company into liquidation simply because the company itself may not have sufficient assets to meet the liquidator's charges and a liquidator may not be prepared to act in those circumstances unless the creditor seeking to have the company liquidated guarantees any shortfall. The Court will not fund a liquidation itself, nor will it put a company into liquidation unless there is someone (and it will invariably require that that person be a chartered or certified accountant) is prepared to undertake the task of liquidator.

2. It is not possible for a company's Articles of Incorporation to exempt a director (or any other person) from liability for fraudulent or wrongful trading. Before the provisions relating to fraudulent and wrongful trading came into force, it was common for a company's Articles of Incorporation to contain a very wide exemption from liability of the officers of the company. Such provisions are now invalid to the extent that they purport to exempt from liability for fraudulent or wrongful trading or any other provision of the company law under which personal liability may be incurred. However, these provisions do not prevent insurance for directors being purchased and paid for by a company.

3. The provisions relating to fraudulent and wrongful Trading apply only to Guernsey companies. A person cannot incur personal liability under the Guernsey provisions relating to fraudulent and wrongful trading by acting as a director of a non-Guernsey company. It may be, of course, that the laws of the jurisdiction in which the company is incorporated will have parallel provisions in relation to fraudulent and wrongful trading with those set out in Guernsey law, so that the director of a non-Guernsey company may incur liability under those parallel provisions.

4. The provisions relating to wrongful trading do not create any criminal liability on the part of a director; only potential civil liability. Fraudulent trading has been made a criminal offence by the 2008 Law.

Fraudulent trading

If in the winding up of a company it appears that any of the company's business has been carried on with intent to defraud creditors or for any fraudulent purpose, the Court (that is, the Royal Court) may, on application of the liquidator, declare that any persons who were knowingly parties to the fraudulent trading are liable to make contribution to a company's assets. In other words, the person who has committed the fraud would be obliged to pay the amount judged as due by him back to the company so that it could be distributed between the creditors of the company by its liquidator. It should be noted that in order to fall foul of the fraudulent trading provisions the behaviour in question must constitute "fraud". The Courts have not defined the meaning of "fraud", but simply restricted themselves to saying that it denotes dishonest behaviour, which is not terribly helpful. Certainly, in order for there to be liability under the fraudulent trading provisions, there must be an intention to de-fraud which has to be proved by showing that the person whom it is sought to make liable had the necessary intent. By way of example:

a) Fraudulent trading will normally be established where the directors of a company, knowing that it has no prospect of ever paying its debts, incur further debts.

b) There will not normally be a case of fraudulent trading where a company ceases trading but, before it goes into liquidation, the directors sell its assets and use the proceeds to pay off only some of its creditors (with a view, for example to currying favour with those creditors for the purposes of a replacement business which the directors propose to establish). However, this type of behaviour would almost certainly constitute the giving of unlawful preferences to creditors which could be set aside at the instance of a liquidator, and might also constitute wrongful, rather than fraudulent, trading.

Wrongful trading

Realistically, it is far more likely that an action will be brought for wrongful trading, rather than fraudulent trading. As mentioned above, the provisions in Guernsey law in relation to fraudulent and wrongful trading are taken almost verbatim from the parallel English law provisions. However, these provisions were not introduced simultaneously into English law. Provisions in relation to fraudulent trading have existed for many years, whereas provisions in relation to wrongful trading were only introduced in 1986. Fraudulent trading had been notoriously difficult to establish because of a requirement to prove dishonesty on the part of the person against whom it was alleged. The Cork Report, which suggested the introduction of wrongful trading provisions in England, also suggested that these provisions should replace, rather than be in addition to, the provisions in relation to fraudulent trading. However, this was not done and Guernsey has adopted wholesale both sets of provisions. In practice, it is the provisions in relation to wrongful trading which are likely to cause the most worry to an honest director, as they can result in personal liability being incurred simply as a result of the director not having kept up sufficiently with the affairs of the company.

Liability for wrongful trading may arise where in the course of the winding up of a company certain conditions apply in relation to a person who is or has been a director of the company. These are that:

(a) the company has gone into insolvent liquidation;

(b) at some time before the commencement of the winding up of that 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.

If these conditions are met, the Court may, on the application of the liquidator of the company, declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper. It is a defence to

an action for wrongful trading if the director against whom it is alleged can satisfy the Court that, after he knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation, he took every step with a view to minimising the potential loss to the company's creditors that he ought to have taken.

The danger which these provisions represent for directors is in imposing potential personal liability on the directors not only when they knew that things were going wrong but where they ought to have known that they were going wrong. If a director is managing a company and at some point that director ought to have concluded that there was no prospect of that company avoiding going into insolvent liquidation, then he will normally be liable for the losses of the company incurred after that time unless he can raise a defence to the effect that he took not only some steps but every step which he ought to have taken with a view to minimising the potential loss to the company's creditors. The difficulty to which this potential defence gives rise is that if a director is potentially liable on the basis of what he ought to have known but did not in fact know, then he is unlikely to be in a position to take steps to minimise a potential loss to creditors.

The wrongful trading provisions in the law apply to a shadow director. A shadow director is a person in accordance with whose directions or instructions directors of a company are accustomed to act. This means, for example, that where a Guernsey company has local directors and a non-resident beneficial owner from whom those directors seek instructions as to how the company should be operated, the non-resident beneficial owner may also be liable under the wrongful trading provisions, even though he is not formally a director of the company.

At this stage, it is worth noting the position in relation to "nominee" directors. As mentioned above, if the beneficial owner of a company actually controls its activities, he may be liable even though he is not a director, on the basis that he is a "shadow director". That does not mean, however, that local "nominee" directors will be exempt from liability simply because the non-resident beneficial owner is liable and controls the company; they could all be liable together. Simply because a director is acting as a nominee does not prevent him from having all the usual obligations of a director, and, whilst it is possible that a court might view the position of a nominee director as being effectively non executive, and not expect such a thorough and up to date knowledge of a company's affairs as an executive director, a person in that position will still be liable if a company becomes insolvent if he has failed to keep himself sufficiently up to date with the company's affairs, by insisting, for example that accounts are produced in a timely manner. It will not be sufficient for the director in this position simply to continue to pester the beneficial owner for accounts, or for information to prepare accounts, if they are never forthcoming. It is up to the directors of a company to ensure that accounts are prepared in accordance with the law, and it will be no excuse to an action for wrongful trading after the company becomes insolvent that the business of the company was carried out entirely by its beneficial owner who never supplied accounts or information to prepare them.

The provision which states that shadow directors may be liable for wrongful trading also means that potential liability for wrongful trading cannot be avoided by using the device as having a company (the "director company") as the director of another company (the "client company"). In those circumstances, if the client company went into insolvent liquidation, then whoever controlled the director company could be personally liable as a shadow director of the client company.

What then should directors do to avoid personal liability for fraudulent or wrongful trading? With regard to fraudulent trading, the answer is fairly simple; do not act dishonestly. With regard to wrongful trading, the answer is more complex. There are 2 stages:

a) In order to avoid being in a situation where he is not in a position to judge whether or not there is any reasonable prospect of a company avoiding going into insolvent liquidation, the director must keep himself up to date with the affairs of the company. The extent to which he must do this will vary depending on the nature of the functions carried out by the director in relation to the company. For example, a non-executive director will not be obliged to keep up with the company's affairs to the extent that an executive director would be. However, even a non-executive director should expect to see regular accounts and, obviously, should consider their content.

b) What should a director do if he comes to the conclusion that there is no prospect of an insolvent liquidation being avoided? The answer before the provisions relating to fraudulent and wrongful trading were introduced was frequently that a director could protect himself simply by resigning his position. Whilst this was probably not effective if all of the directors resigned en masse without replacements being appointed, it was often good advice in the case of an employed director with no significant shareholding in a company who found out that his employer's business was on the rocks. Nowadays, this would be just about the worst possible thing that a director could do. He really has 3 options:

i) He can procure that the company is put into liquidation. This is the ideal solution in just about every circumstance imaginable. If a director realises that there is no prospect of the company avoiding insolvent liquidation, then there is no better step to avoid further loss to creditors, and thereby give himself a defence against an action for wrongful

trading, than if a liquidator is appointed to realise the assets of the company and distribute them on a "pari passu" basis between the creditors.

There are 2 types of liquidation in Guernsey law: voluntary and compulsory. In the case of voluntary liquidation, the shareholders of the company appoint the liquidator themselves and there is no requirement that the liquidator should have any particular qualification. In a compulsory liquidation, a liquidator is appointed by the Court and the Court will invariably require that an independent chartered or certified accountant be appointed. Compulsory liquidation will almost invariably be the appropriate route where a company is insolvent. It is worth mentioning at this point the possibility of a provisional liquidator being appointed by the Court. Provisional liquidation has the benefit that a liquidator is appointed by the Court, as in the case of a compulsory liquidation, so as to give the director who has realised that his company is in trouble the same protection as in the case of a normal liquidation, but the liquidation can be reversed if, the liquidator having carried on the business of the company, it is bought back to a state of solvency.

The difficulty with a director who realises his company has no prospect of avoiding insolvent liquidation appointing a liquidator is that the liquidator may require a guarantee in respect of its charges to take account of the possibility that the assets of the company may not be sufficient to meet them.

ii) If a director is genuinely not in the position to procure the appointment of a liquidator, for example if he cannot find anyone willing to act, the best advice would generally be that the business of the company should be discontinued completely. If this course of action is taken then it is important that no creditors are paid at this stage. The directors should not attempt to wind the company up informally by selling off its assets and paying off the creditors, as there is a substantial risk that one creditor might be unlawfully preferred over another and the director would not then have the defence of having taken all reasonable steps to minimise potential loss to creditors.

If a director does not ensure that a liquidator is appointed, then there could be some tricky problems. It is suggested above that, generally, if no liquidator is appointed, then simply stopping the company's business dead is normally the best alternative route. There could, however, be cases where that was not the case. Take for example a director who realises that his building company has no prospect of avoiding insolvent liquidation. However, the company is two-thirds of the way to completing a contract. If the company ceases business now, it will receive nothing from the contract. Should the company's business be carried on to complete the contract? If the business simply stops, can the director who stops it be said to have taken every step with a view to minimising potential loss to the company's creditors which he ought to have taken? Could it not be argued that the contract ought to have been completed? Conversely, in the process of completing the contract, what if the company incurs further debts to suppliers? Again, it can be argued that the director has not taken every step with a view to minimizing potential loss to the company's creditors. Clearly the director here is in invidious position, which does demonstrate that the liquidation route is, in almost all circumstances, the preferable one.

iii) He can place the company into administration. Administration is an alternative to winding up and is intended to be used where a company is in difficulties but where something may be saved. For this reason it may be of particular interest to creditors who are owed money by the struggling debtor company and where in liquidation proceedings such creditors may not obtain the full amount they are owed.

In order to obtain an administration order the applicant must show to the Court that the company does not satisfy or is likely to become unable to satisfy the solvency test as laid down in the 2008 Law, and considers that the making of an order may achieve the survival of the company and the whole or any part of its undertaking, as a going concern; or a more advantageous realisation of the company's assets than would be effected on a winding up.

During the period between the presentation of an application for an administration order and following the making of such an order no resolution may be passed or order made for the company's winding up; and no proceedings may be commenced or continued against the company except with the consent of the administrator or the leave of the Court and subject to such terms and conditions as the Court may impose.

Following an administration order any order for the company's winding up shall be discharged or suspended or any resolution for voluntary winding up shall cease to have effect or shall be suspended (as the case may be).

When an administration order is made, the Court will appoint an administrator. The administrator may do anything that is necessary or expedient for the management of the affairs, business and property of the company. He may apply to the Court for directions to the extent or performance of any function and any matter arising in the course of his administration; remove any director of the company and appoint any person to be a director of it, whether to fill a casual vacancy or otherwise; and call any meeting of the member or creditors of the company.

The administrator may at any time apply to the Court for the administration order to be discharged or varied if it appears to him that the purpose or each of the purposes specified in the order has been achieved or is incapable or

achievement; or it would otherwise be desirable or expedient to discharge or vary the order.

RIDER

This paper is intended as a general review and aide memoire. It does not create a retainer or lawyer-client relationship and does not provide comprehensive or specific legal advice concerning the matters contained within it. This paper should not be relied upon as giving or providing advice on any individual case.