Interests of creditors are paramount where a company is insolvent (Wessely and another v White)

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Restructuring & Insolvency analysis: What constitutes a breach of fiduciary duty by a company director? Christopher Brockman of Enterprise Chambers discusses a ruling that a director did not act in breach of duty where he acted in what he honestly believed to be in the interests of everyone, including the creditors.

Wessely and another (Joint Liquidators of Laishley Ltd, in Liquidation) v White [2018] EWHC 1499 (Ch), [2018] All ER (D) 128 (Jun)

What are the practical implications of the case?

In a case where an office-holder alleges breach of fiduciary duty against a director, the initial burden of proof is on them to prove the breach and the loss. While the burden of proof may shift to the director once a prima facie case is established by the office-holder—for example where payments are proved to be made to a director—it is for the director to show that they were justified, but that does not displace the initial burden on an applicant office-holder.

An office-holder cannot rely upon a witness of fact, however well qualified, to give expert opinion evidence as to the value of a claim. It will always be necessary to factor in the need for expert evidence where the quantum is based on an assessment of value by a professional.

Finally, the case reinforces the now well-known principle that where a company is insolvent, the interests of creditors are paramount.

What was the background to the case?

The applicant liquidators of a company applied for equitable compensation for alleged breaches of fiduciary duty by the respondent managing director of the company.

The company was a building contractor. It ceased trading during the week of 10 May 2010 because of its financial situation, and went into administration on 9 June 2010. It was placed into creditors' voluntary liquidation in 2011. At the time of ceasing to trade, the company was performing a number of building contracts including the construction of a health centre and the conversion of an office building. In relation to each of the two contracts, the directors, on behalf of the company, executed deeds of release on 14 May and 20 May 2010, by which both the employer and the company were released from future performance under the contracts but the employer was also released from liability in respect of any payment obligations.

They had taken advice from insolvency practitioners who had advised that novation was a way to avoid the termination of the existing contracts by bringing in a new company to take over the performance of those contracts. The managing director gave evidence that he had considered that novation would prevent the employers from suffering any loss, the employees would still be employed and the creditors would not lose as much as they would otherwise so that it would be the best outcome in difficult circumstances. He maintained that he had not properly understood the process of novation, including that novation had to take place before the contracts were terminated.

Several large contractors had expressed an interest in taking over the company's contracts, and the highest bidder offered £75,000 and £200,000 for each contract. However, because the contracts had been terminated by the deeds of release, there was nothing left to novate.

The liquidators alleged that the entry into those deeds of release by the director on behalf of the company constituted a breach of his duties owed to the company under the section 171 of the Companies Act 2006 (CA 2006) (the duty to act in accordance with the company's constitution), and CA 2006, s 172 (the duty to act in good faith to promote the success of the company) in causing the company the loss of the value of the contracts if they had been novated and the loss of the rights to payments due under the contract at the time the deeds of release were entered into.

What did the court decide?

Breach of duty

Where a company was insolvent, the duty to act in the best interests of the company was regarded as a duty to act in the best interests of its creditors as a whole, and the creditors' interests became paramount: *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch), [2013] All ER (D) 240 (Sep) followed.

In circumstances where there was evidence of actual consideration of the best interests of the company and no material interest had been overlooked without objective justification, the test to be applied was subjective rather than objective.

The question was whether the director honestly believed that his act or omission was in the interests of the company: *Regentcrest Plc (in liquidation) v Cohen* [2000] Lexis Citation 3122, [2000] All ER (D) 747 applied. There was evidence in the present case that the director had considered the best interests of the company, taking account of all the relevant matters referred to in CA 2006, s 172(1), as well as the interests of the company's creditors.

The director had to be judged at the time that the acts complained of were committed and in the context of how the situation appeared to him then, *Re Living Images Ltd* [1996] 1 BCLC 348 applied. At the time, having no prior experience of running an insolvent company and under pressure, he genuinely considered that a novation of the company's contracts would be in the interests of everyone—including the creditors—and he genuinely considered, on the advice of trusted professionals, that signing the deeds of release would be the first step in obtaining those novations. That was the director's mistake but, judged subjectively, it was not a breach of his duties.

Causation of loss

Even if the director had been found to be in breach of his duties, the court was not persuaded that entry into the deeds of release had caused any of the losses complained of. Only a contractor of considerable substance would have been able to take over the contracts. A balance sheet for the only bidder showed that it had total net assets of £44,514 and there was no evidence to show how it would be able to finance even the payment of the initial bids, let alone the ongoing works and expenses.

The evidence of the value of the loss of rights to payments due under the contract at the time the deeds of release were entered into came from an assessment by the quantity surveyor engaged by the applicants at the time, who the court found to be a witness upon whose evidence it could not place a great deal of reliance. In any event he was a witness of fact and not the appropriate person to act as an expert witness: *Re Colt Telecom Group plc (No 2)* [2002] EWHC 2815 (Ch), [2002] All ER (D) 347 (Dec). No permission had been given for expert opinion evidence to be adduced, and accordingly there was no admissible evidence on the value of the contracts. In the circumstances the court was unable to find that the equity due to the company in respect of each of the contracts had any value at all. The company could not be shown to have lost anything of value.

Burden of proof

It was argued by the applicants that the burden of proof was on the director to show that his actions did not cause loss to the company. That argument was rejected by the judge who found that in a claim for equitable compensation for breach of fiduciary duty, the burden was on the applicants to prove the breach and the losses said to flow from the breach: *Swindle v Harrison* [1997] 4 All ER 705.

The application was therefore dismissed and the liquidators ordered to pay the director's costs with an interim payment on account of £60,000.

Christopher Brockman of Enterprise Chambers appeared for the director. His practice areas include breach of directors' duty cases acting for office holders and directors (including the only reported decision on the use of employee benefit trusts as tax avoidance schemes), asset recovery on behalf of insolvency office holders, 236 applications to examine directors and examination of directors, defending trustees against claims for negligence/breach of duty and bankruptcy restriction orders. He acts for the Secretary of State on various applications, including company directors disqualification proceedings and public interest petitions. In the recent past Chris had been involved in several high-profile personal and corporate insolvency cases, and is frequently instructed by HMRC in relation to complex applications including on a number of provisional liquidations.

Interviewed by Barbara Bergin.

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