Directors' Duties in the Zone of Insolvency:
Is it proportionate to criminalise breaches of directors' duties and obligations?
A brief analysis of the approaches taken in the UK, New Zealand and Cayman Islands

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1. Introduction

Directors perform an essential role in the day-to-day operation and supervision of corporate entities. The role of the director is complex at the best of times, but navigating issues which arise when the relevant entity is in financial difficulty can make the position even more complicated.

If action is taken prematurely at the first sign of trouble, directors may be blamed for causing needless or amplified damage to stakeholders. If action is taken too late, there may be harsh consequences for directors who allow a company to engage in wrongful or insolvent trading. Therefore, as a company enters the "zone of insolvency", directors have difficult and nuanced decisions to make.

There have been several high-profile decisions in connection with allegations of reckless trading against directors in recent times. In New Zealand, guidance has resulted from the collapse of former property and construction heavyweights (see *Debut Homes* and *Mainzeal*). In the Cayman Islands, appellate level judgments have arisen out of large-scale fund insolvencies and the roles of directors in the lead-up to catastrophic failures (see *Weavering* and *Primeo Fund*). In the UK, as temporary provisions and leniency in relation to COVID-19 have lapsed, the courts will no longer give a director the benefit of the doubt for any worsening of the financial position of the company.

Accordingly, as the fallout from the global pandemic intensifies and companies battle to survive, it is submitted that it is an important time to re-assess whether criminal sanctions are an appropriate response to serious breaches of certain directors' duties.

2. Undivided loyalty – but to whom?

When considering whether directors should be held criminally liable for breaches of the duties they owe to stakeholders, it is imperative to have an understanding of the fundamental role and function they perform.

From at least 1742[1], when Lord Hardewicke LC described the role of the director as being similar to that of a trustee and held that directors owed duties of "*fidelity, integrity and diligence*", the common law has recognised that directors are fiduciaries.

The concept of a fiduciary originates in the law of equity, and is influenced by the concept that a person who has been placed in a position of trust should protect the interests of those s/he is appointed to serve. Fiduciary duties are imposed upon directors in order to deter them from acting against the company's interests. Fulfilling fiduciary duties involves honesty, loyalty and good faith - not necessarily competence.

Lord Millet[2] described the role of the fiduciary as follows:

> *"The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal."* (emphasis added)

The duty of loyalty to act in the best interests of the company is the overarching standard and the other fiduciary duties stem from there. The UK Law Commission identified five additional categories of fiduciary duties as part of a review in 1998[3] and other common law jurisdictions broadly adopt the same sub-headings: (i) a duty to act for a proper purpose (to exercise powers for the purpose for which those powers were conferred); (ii) a duty not to fetter their discretion; (iii) the no conflict and no profit rules; (iv) a duty to act in accordance with the company's constitution; and (v) a duty to act fairly as between different shareholders.

The analysis of the core duty of loyalty changes at the time when the company becomes doubtfully solvent. The focus morphs from maximising value for and acting in the best interests of the entire body of shareholders to treating the creditors' interests as paramount. Directors' fiduciary duties are enforceable by the company alone and not by its creditors. However, directors will owe duties to the company's creditors from the date the directors form (or should have formed) the view that the company may not be able to continue to trade due to financial difficulties. From that point onwards, the actions of the directors, both collectively and individually, will likely be heavily scrutinised.

The priority of the directors must be to avoid self-interest with a view to preserving and protecting value. Directors must be very cautious before embarking on a course of continued trading, in the hope that this will enable the company to restore solvency[4].

If a director of an insolvent company is also a director of a related solvent company, he or she must be sure, through full disclosure, to avoid a situation where the duties owed to the shareholders of the solvent company and the creditors of the struggling company give rise to any conflict.

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[1] *The Charitable Corporation v Sutton* (1742) 2 Atk 400.

[2] *Bristol and West Building Society v Mothew* [1998] Ch 1 at [18]; see also Lord Browne-Wilkinson in *White v Jones* [1995] 2 AC 207 at [231]

[3] Law Commission Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties (Consultation Paper No. 153).

[4] *Fatupaito v Bates* [2001] 3 NZLR 386 (HC)

The "*singled-minded*" nature of the duty to the company always remains constant. However, the priority given to the interests of the classes of stakeholders may switch as the company moves between states of solvency as those with the true economic interest in the company may shift in unison.

3. Director in name or director by conduct?

Although it may seem counter-intuitive, when considering who is or is not a director for the purpose of determining who owes fiduciary duties to the company, titles are often largely irrelevant. Irrespective of what the individual calls himself or herself, the individual is likely to owe directors' duties if performing the functions of a director.

As observed by Middleton J of the Federal Court of Australia[5]:

> *"A director is an essential component of corporate governance. Each director is placed at the apex of the stature of direction and management of a company. The higher the office that held by a person, the greater the responsibility falls upon him or her."*

Generally, a director will be an individual expressly appointed under the company's constitutional documents. Depending on the circumstances, other individuals may also owe fiduciary duties to the company as if they were directors by appointment.

As a matter of Cayman Islands law, for example, it was recognised by the Grand Court in the high-profile case of *Weavering*[6] that the appointed directors played a purely formal role in the management of the fund and allowed Magnus Peterson to run things. He was described as the "*controlling mind*" in the judgment and was labelled as a *de facto* director. It is clear that, to be considered a *de facto* director, the functions performed by the individual must be directorial in nature and must surpass functions which could be performed by a manager reporting to the board[7].

The English courts also recognise the concept of a *de facto* director and have set out various considerations which may be taken into account when arriving at that finding. The courts may analyse whether the person was held out as a director, whether the person has proper information upon which to make decisions and whether the person made major decisions[8].

Similarly, certain individuals may be classified as "shadow directors." This concept is defined at section 89 of the Cayman Islands Companies Act as "*any person in accordance with whose directions or instructions the directors of the company are accustomed to act, but the person is not deemed to be a shadow director by reason only that the directors act on advice given by him in a professional capacity.*" This is designed to draw a distinction between third party professional advisors (such as auditors and lawyers) and other individuals with a degree of control over decision-making.

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[5] *ASIC v Healey* [2011] FCA 717 at [14]

[6] [2015] (2) CILR 278

[7] *Re Hydrodan (Corby) Ltd* (in liquidation) [1994] BCC 161 at 163

[8] See, for example, the analysis set out in *Secretary of State for Trade and Industry v Tjolle* [1998] 1 BCLC 333

In *Hutchinson Ltd v Cititrust (Cayman) Ltd*[9]*,* Douglas AJ compared *de facto* and shadow directors by reference to the seminal decision of Millett J (as he then was) in *Re Hydrodan*[10] when he said that:

> *"A de facto director is one who claims to act and purports to act as a director, although not validly appointed as such. A shadow director, by contrast, does not claim our purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself."*

In an insolvency situation, many of the same duties and obligations that apply to formally appointed directors are also applied to *de facto* and shadow directors. In rare circumstances, a senior manager may also be treated as a director and imputed with similar fiduciary duties. For example, in *Cayman Islands News Bureau Ltd v Cohen et al*[11], Harre J (as he then was) held that as a senior officer with major responsibilities, Mr. Cohen owed fiduciary obligations to the company and was required to observe extra-contractual standards of loyalty and good faith.

The leading UK decision on fiduciary duties owed by employees is *Nottingham v Fishel*[12] *where Elias J observed that: "it is necessary to identify with care the particular duties undertaken by the employee, and to ask whether in all circumstances he has placed himself in a position where he must cat solely in the interests of his employer."*

As such, it is important to note that, as a matter of law in each of the subject jurisdictions, there is a wide range of individuals who may be exposed to liability for breaches of fiduciary and non-fiduciary duties owed to a particular company in the "zone of insolvency" or otherwise.

4. Comparison of approaches in three common law jurisdictions.

Each of New Zealand, the UK and Cayman Islands impose civil liability on directors for breaches of their duty to act in good faith and in the best interests of the company. Unlike in the United Kingdom and the Cayman Islands, New Zealand has enacted legislation which provides for potential criminal sanction for a breach of the core duty to act in good faith. Whilst the United Kingdom[13] and New Zealand[14] have codified fiduciary duties in their respective company legislation, the Cayman Islands relies almost exclusively on a common law framework. It is useful to compare approaches by reference to recent leading decisions in each jurisdiction.

New Zealand

Australia is renown for implementing a relatively heavy-handed approach to breaches of director's duties. The Australian approach has been described as both "e*xcessively penal*" and "*obese and user-*

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[9] [1998] CILR 43

[10] See [6] above.

[11] [1988-89] CILR 195

[12] [2000] ICR 1462

[13] ss. 171 to 176 of the UK Companies Act.

[14] ss. 131, 133, 137 and 145 of the New Zealand Companies Act.

unfriendly"[15]. New Zealand has followed suit to an extent, but has not gone quite as far with shorter prison sentences and lower fines. As well as fraudulent trading liability, a director of a New Zealand company may be held criminally liable for a prison term not exceeding five years if s/he dishonestly violates the duty to act in good faith and in the best interests of the company[16].

Perhaps the most interesting and high-profile examination of liability for breaches of director's duties in New Zealand in an insolvency context arises out of the claims brought by liquidators of Mainzeal Property and Construction Ltd. The case has garnered a great deal of media attention, particularly due to the involvement of ex-New Zealand Prime Minister Dame Jenny Shipley as a former non-executive director of the construction firm.

There are two relevant heads of claim in the Mainzeal litigation. According to the Court of Appeal judgment[17], the liquidators assert that the Mainzeal directors: (i) agreed to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to creditors, in breach of section 135 of the New Zealand Companies Act; and (ii) agreed to the company incurring obligations to creditors at a time when they did not have reasonable grounds for believing that the company would be able to perform those obligations when required to do so, in breach of section 136 of the New Zealand Companies Act.

The approach adopted by the directors was said to have involved a large measure of wishful thinking and failures to (i) squarely address risks identified by professional advisors and (ii) seek external independent advice in relation to certain specific items.

In a memorable line from the Court of Appeal judgment, it was said that "*sometimes it is necessary to bite the bullet and take steps that will trigger an administration or an insolvent liquidation, and failure to do so will result in liability*". The Court of Appeal held that urgent corrective action was necessary and that if none of the identified courses of action bore fruit, the directors could have, and should have, resigned. As it turned out, the directors continued to trade in a reckless manner and took on various new obligations.

In *Mainzeal*, the New Zealand Court of Appeal awarded compensation on a "new debt" basis in line with another recent decision of the New Zealand Supreme Court in *Debut Homes Limited*[18]. They noted that an award of compensation on this basis fairly reflects the harm done to new creditors, who would not have had an exposure to the company if the directors had not agreed to the company incurring the relevant obligations. Therefore, the New Zealand courts adopt a "look-forward" approach to recoverability from directors at the point from which they are not justified in taking on new debt and continuing to trade.

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[15] John Farrar "*Corporate Governance: Theories, Principles and Practice"* (3rd ed, Oxford University Press, Melbourne, 2008) at 7

[16] See ss.138A and 373(4) of the New Zealand Companies Act

[17] [2021] NZCA 99 – judgment delivered on 31 March 2021

[18] *Debut Homes Limited (in liquidation) v Cooper* [2020] NZSC 100

The New Zealand Supreme Court (i.e. New Zealand's highest court) granted leave to appeal on 6 September 2021 and is due to hear the final appeal[19]. As things stand, the Mainzeal directors are liable for approximately NZ$63.551 million in compensation to the Mainzeal liquidation estate subject to a further hearing on quantum, but have no exposure to criminal suits.

In response to the pandemic, on 3 April 2020[20], the New Zealand Government introduced a "safe harbour" regime which provided a degree of protection for directors in relation to potential reckless trading claims. This was, at least in part, designed to encourage directors to stimulate, rather than stifle, economic recovery. The "safe harbour" exemptions expired on 30 September 2020.

The United Kingdom

Section 212 of the contains a summary procedure for seeking relief against delinquent directors and others where a company has gone into liquidation. This remedy is available where a director or officer has misapplied funds or breached any duty in relation to the company (including fiduciary duties and negligent conduct). This also applies to *de factor* directors[21]. The offending director may be ordered to pay compensation as a result of proven misconduct. If a liquidator can establish that a payment was made, the onus is on the director or officer to explain the transaction[22].

The Insolvency Act also includes fraudulent trading provisions which may attract criminal liability, such as fraud in anticipation of winding up and transactions to defraud creditors[23]. The difficulty with claims as a result of alleged fraudulent trading, in many common law jurisdictions, is that it is necessary to show intent to defraud. This is typically a high evidential burden[24], but a guilty verdict is very likely to lead to a custodial sentence.

At common law, the English courts have confirmed that directors may defend a claim for breach of duty by reasonably relying on information or advice[25]. There may also be limitation defences where the relevant conduct is more than six years' old, unless there are exceptional circumstances based on, say, fraud or concealment.

As a result of large institutional banking and financial services failures, the UK has also introduced a new criminal offence of causing a financial institution to fail. There is specific legislation dealing with this charge under the Financial Services (Banking Reform) Act 2013. There is scope for criminal liability where a senior manager takes or agrees to a decision on behalf of a financial institution where the implementation of the decision causes the failure of the relevant group or entity. An individual may be

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[19]See judgment in *Richard Ciliang Yan v Mainzeal Property and Construction Ltd (in liquidation)* [2021] NZSC 109. See also New Zealand Herald article entitled "Supreme Court to hear appeal in long-running litigation after collapse of construction firm Mainzeal" published on 6 September 2021

[20] See COVID-19 Response (Further Management Measures) Legislation Act

[21] See, for example, *Holland v HM Revenue and Customs, Re Paycheck Services 3 Ltd* [2010] 1 WLR 2793.

[22] See, for example, *Re Idessa (UK) Ltd* [2012] 1 BCLC 80 at [28]

[23] ss. 206 and 207.

[24] See, for example, the explanation in *R v Carass* [2002] 1 WLR 1714, CA.

[25] See, for example, *Green v Walkling* [2007] EWHC 3251 (Ch).

liable for up to seven years in jail pursuant to this legislation. According to Claire Sibson QC, in her chapter on 'Criminal Liability of Directors' in *Mortimore* on Company Directors[26], it is "*expected that prosecution under this section will be few and far between*".

Compensation and disqualification orders are also available under the UK Company Directors Disqualification Act 1986. Like New Zealand, the UK also temporarily suspended wrongful trading rules in light of the strain of the pandemic[27].

<u>Cayman Islands</u>

The Cayman Islands has a similar regime to the United Kingdom in relation to criminal liability imposed on directors. The Cayman Islands Companies Act includes provisions related to fraud in anticipation of winding up, fraudulent transactions, fraudulent trading and omitting material information.

In 2014[28], the Cayman Islands Law Reform Commission examined whether common law fiduciary duties and the duty of care and skill of company directors should be codified to promote consistency in corporate governance. Whilst the Cayman courts have shown a reluctance to review judgments of directors which have been taken in good faith, on occasion they have also refused to excuse directors from liability where they have acted fairly and honestly. Therefore, this has led to uncertainty amongst independent non-executive directors in particular.

Unlike the UK and New Zealand, the vast majority of Cayman Islands companies operate overseas. Therefore, it is common to have independent non-executive directors on the boards of such companies who are required to perform a high level supervisory function rather than the more "hands-on" approach which might be expected of their onshore counterparts.

That being said, recent decisions of the Cayman courts highlight that non-executive directors will not be absolved of responsibility if they are found to be "*asleep at the wheel*". In *Weavering*, it was not alleged that the directors had acted in breach of their fiduciary duties. The case against the directors was that they had acted in breach of their duty to exercise independent judgment and to exercise reasonable care, skill and diligence.

In the Cayman Islands, there is a minimum objective standard of care based upon the functions given to the director, but that standard may be elevated where the director in question has more knowledge, skill and experience than would normally be expected. This is particularly important in the Cayman Islands because independent directors are often appointed for their very specific and unique skillset (e.g. crypto experts).

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[26] "Company Directors: Duties, Liability and Remedies" (3rd Edition) edited by Simon Mortimore QC

[27] Corporate Insolvency and Governance Act 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and Extension of the Relevant Period) Regulations

[28] See 2014 LRC Issues Paper *"Directors' Duties – Is Statutory Codification Needed?"*

It was confirmed in *Weavering* that, even non-executive independent directors, have a continuing duty, both collectively and individually, to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them to properly discharge their duties as directors[29].

The unique position of many directors of Cayman Islands companies may have an impact on whether or not it is proportionate to impose criminal sanctions on directors. Put simply, those who are closer to the operational side of the business may have more control over reckless and fraudulent trading than a non-executive director with a supervisory function in the Cayman Islands.

5. What is proportionate in these unprecedented times?

The desperation that is linked to a post-pandemic trading environment may lead to directors and officers pushing the boundaries of recklessness. It goes without saying that actual fraud may result, and indeed should result, in criminal liability. However, reckless behaviour or conduct falling below the standard of utmost good faith are more challenging to legislate for or rule upon.

There is a difficult balance between reasonableness and futility. Fear of liability may create a situation where directors feel they cannot act freely and take appropriate business risks. This could lead to directors trying to act overly prudently and risk free, inhibiting the development of the company. It is vital to acknowledge that directors are not required to "*get it right*" every time. A director is not automatically negligent or culpable if the company suffers a loss as a result of his actions[30].

As observed by William Young J in *Re South Pacific Shipping Ltd (in liq)*[31]:

> *"No-one suggests that a company must cease trading the moment it becomes insolvent (in a balance sheet sense). Such a cessation of business may inflict serious loss on creditors and, where there is a probability of salvage, such loss can fairly be regarded as unnecessary. The cases, however, make it perfectly clear that there are limits to the extent to which directors can trade companies while they are insolvent (in the balance sheet sense …) in the hope that things will improve. In most of the cases, the time allowance has been limited, a matter of months."*

This tends to suggest that the common law will provide a period of leniency in most circumstances where it is not obvious that the company is doomed to fail. Only time will tell whether this period is extended and directors are given more leeway due to extenuating macro-economic factors arising out of the pandemic.

Although legislators around the world, including in New Zealand and the UK, have sought to give directors some breathing space during the pandemic, those are not permanent measures. It seems likely that the goalposts have moved for the time being in relation to criminal sanctions as a result reckless or wrongful trading. However, as the world begins to return to some level of normalcy, directors would be wise to

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[29] *Re Barings PLC, Secretary of State for Trade and Industry v Baker (No 5)* [1999] 1 BCLC 433, 439, confirmed in all *Weavering* judgments.

[30] *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425

[31] (2004) 9 NZCLC 263,570 (HC).

reassess any cavalier tendencies that have developed while they have had the benefit of a perceived "free pass."

Practically speaking, the author submits that directors of companies in insolvency scenarios should keep the following points under constant review with the benefit of reputable independent advice where possible:

- dealing openly and honestly with creditors and maintaining regular dialogue with them;
- not assuming they cease trading, as doing so may not be the best way to minimise loss;
- not assuming they should resign as this may be counter-productive;
- making the best forecasts reasonably possible in the short to medium term; and
- considering what cost-cutting measures may be sensibly adopted and adopt them.

If directors can demonstrate that they have acted swiftly and sensibly in the circumstances, the specific common law regimes referred to above, and their respective approaches, are unlikely to matter (i.e. regardless of the trading environment or external factors).

As emphasised at the outset by reference to the core and irreducible duties of a director, single-minded loyalty is paramount and if directors can demonstrate that they had the stakeholders' best interests at the front of their minds at the time they made a particular decision, it seems to the author that criminal liability is generally going to be disproportionate and even more so in an unprecedented trading environment.

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