How to run a wrongful trading case

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Restructuring & Insolvency analysis: Discussing the judgment in Ralls Builders Ltd (No 2), Christopher Boardman, a barrister at Radcliffe Chambers, says the case is an illuminating example of the problems and difficult decisions directors of insolvent companies face when considering how to properly conduct themselves and avoid potential liabilities.

Original news

Re Ralls Builders Ltd (in liquidation); Grant and another v Ralls and others [2016] EWHC 1812 (Ch), [2016] All ER (D) 113 (Jul)

The Chancery Division ruled that, having found that the joint liquidators' application, under section 214 of the Insolvency Act 1986 (IA 1986), for a contribution from the directors of a company on a wrongful trading claim, had failed, it would not be appropriate to make the directors pay a contribution to the assets of the company in respect of the joint liquidators' fees and expenses in investigating and pursuing that unsuccessful claim.

What was the background to this judgment?

This was a claim for wrongful trading pursuant to IA 1986, s 214. The liquidators, Steven Grant of Wilkins Kennedy and James Tickell of Portland, sought a £1.5m contribution to the company's assets from the three former directors of a South East building company that had gone into administration during the course of the last recession. The liquidators alleged that the directors knew or ought to have known by 31 July 2010, alternatively 31 August 2010, that the company could not avoid insolvent liquidation and had taken no steps to protect the interests of creditors until it went into administration on 13 October 2010.

The trial took place in June 2015. In February 2016, the judge handed down his main substantive judgment: *Re Ralls Builders Ltd (in liquidation); Grant and another (Joint Liquidators of Ralls Builders Ltd) v Ralls and others* [2016] EWHC 243 (Ch), [2016] All ER (D) 142 (Feb). The judge found that although the directors ought to have known that the company had no reasonable prospect of avoiding liquidation by 31 August 2010 and had not taken every step to minimise the loss to creditors so as to enable them to rely on the statutory defence in IA 1986, s 214(3), it was not appropriate to order them to make any contribution to the assets of the company because the liquidators had failed to establish that continued trading had caused any loss to the company. Snowden J held that the proper measure of loss to the company for these purposes was the increase in the net deficiency or 'IND' basis, and that the evidence did not establish any IND between 31 August and 13 October 2010. He held, as the directors had maintained, that the decision to continue trading after 31 August 2010 had in fact produced a slightly better result for creditors as a whole and that a worse result to some creditors did not represent a loss to the company which the directors ought to be required to contribute to.

PSL practical point: For further reading on the main substantive judgment, see News Analysis: Actual loss must be shown for a successful wrongful trading claim.

What were the issues before Snowden J?

At the conclusion of his first substantive judgment, the judge reserved for further argument that part of the liquidators' claim which sought an order requiring the directors to make a contribution towards the expenses of the administration and liquidation. Having originally sought an order requiring the directors to pay all of these expenses, at trial the liquidators had advanced a narrower claim merely for 'increased expenses', namely of investigating and bringing their wrongful trading claim.

At the trial, the liquidators had also sought a disqualification order against the directors under section 10 of the Company Directors Disqualification Act 1986. This aspect of the case was adjourned to the further hearing, since a disqualification order can only be made under that provision where the court orders the director to make a contribution to the company's assets.

What were the main legal arguments put forward?

The liquidators contended that because the court had made a finding that trading had continued beyond 31 August 2010, there had been 'wrongful trading' and this gave the court the power to order the investigation costs incurred by the liquidators to be paid by the directors so as to avoid them increasing the net deficiency to the detriment of unsecured creditors.

The directors argued that the sums claimed could not be ordered to be contributed as a matter of principle. They submitted that, as a general rule, expenses incurred on behalf of a litigant in investigating and bringing a claim are not recoverable in damages and that office-holders are in no better position than any other litigant in being unable to recover these as part of their costs of the claim.

The directors also submitted that the costs of investigation of the directors' conduct were not caused by the directors' decision to continue trading after 31 August 2010. They further submitted that was not in accordance with the overriding objective for the liquidators to advance such a claim for investigation costs at the end of a lengthy trial in which they had failed to adduce the evidence to prove their amended claim.

What did Snowden J decide, and why?

After examining the case law, which he accepted demonstrated that, in general, a litigant cannot recover expenses which he incurs in connection with litigation other than by way of an order for costs, Snowden J decided that these principles applied equally to wrongful trading claims so that, as a matter of principle, the liquidators' claimed costs and expenses could not be claimed from the directors by way of contribution to the assets of the company.

Secondly, Snowden J decided that there was no logical basis to distinguish insolvency claims as regards the principle that a litigant cannot recover the value of his time as part of his costs of a claim. There is a limited exception (the *Nossen* principle (*Re Nossen's Letter Patent* [1969] 1 All ER 775)) enabling litigants to recover the cost of providing expert services, but the liquidators had their own expert and their position was no different in principle from any other litigant whose duty involves bringing a legal claim.

Thirdly, Snowden J decided that the costs and expenses claimed by the liquidators were not caused by the directors' decision to continue trading after 31 August 2010. After stating his conclusion that something more than just a 'but for' test of causation is applicable to IA 1986, s 214 claims, the judge accepted that losses that the company sustained as a consequence of going into a formal insolvency could not in principle be laid at the door of the directors.

Fourthly, Snowden J decided that the directors’ conduct had not been wrongful simply because there was a relevant date at which they ought to have concluded that the company could not avoid insolvent liquidation. He considered it wrong to characterise their behaviour as ‘wrongful’ so as to justify ordering them to pay costs subsequently incurred by the liquidators investigating whether there had been an IND. He held that it would be illogical to decline to make any order for contribution because there was no IND, but nevertheless order the directors to pay the liquidators costs of investigating and unsuccessfully trying to prove that a loss was sustained.

Fifthly, he decided that it was not appropriate to permit the liquidators to amend their pleadings, give late disclosure and adduce further evidence to enable the issue of the quantum of their additional costs to be determined at another hearing. After considering the principles on late amendments, he said they militated against the granting of permission particularly given the adverse consequences to the directors and court.

Finally, Snowden J declined to direct a further hearing on notice to the Secretary of State to consider the question of making a disqualification order against the directors. Having concluded that it was not appropriate to require them to make any contribution to the assets of the company, the court’s jurisdiction to make such an order did not arise.

To what extent is the judgment helpful in clarifying the law in this area?

The judgment is of assistance to insolvency practitioners, directors and lawyers in establishing the legal principles applicable to recoverability in wrongful trading and other types of office-holder claims. Snowden J’s analysis highlights that success in wrongful trading claims ultimately depends on the office-holder’s ability to prove that the company has suffered a loss. It further clarifies that principles of the law of damages can apply to wrongful trading claims as they do to other types of claim.

The judgment is of direct application and assistance to parties considering or involved in wrongful trading claims. It clarifies the type of liquidation expenses that may be recoverable, the circumstances in which they can be claimed and the type and timing of the evidence that will be required. However, Snowden J’s analysis has wider application and provides guidance as to the circumstances in which it may be possible to recover investigation and other costs in the context of insolvency claims generally.

Prior to the judgment, there was only one reported authority on the ability of an office-holder to recover liquidation expenses and the principles relevant to them, namely *Re Continental Assurance Company of London plc (in liquidation)* [2001] Lexis Citation 2161, [2001] All ER (D) 229 (Apr). Snowden J’s judgment is the first to consider these principles in the context of a claim for an office-holder’s own time costs. It provides valuable guidance and clarification on the causative and evidential requirements which have to be met if any such claim is to succeed.

One of the most striking aspects of the judgment is the court’s rejection of the liquidators’ argument that a director who continues trading beyond a time when he knows or ought to conclude that his company cannot avoid insolvent liquidation is ‘guilty’ of wrongful trading. Snowden J’s rejection of this submission is as close as any judge has come to explaining what wrongful trading is. It will come as a relief to directors to know that they are not committing wrongdoing by trying to trade a company out of its difficulties for the benefit of its creditors. On the other hand, directors now know that they are potentially at risk if they do this and that it will be very difficult for them to be able to rely on the statutory defence under IA 1986, s 214(3).

What practical lessons can those advising take away from this case?

This case is an illuminating example of the problems facing directors of insolvent companies and the difficult decisions they face when considering how to properly conduct themselves and avoid potential liability under IA 1986, s 214 and generally. The judgment provides valuable insight into how to run a wrongful trading case, the type of damages that can be claimed and the quality of the evidence that will be needed for that claim to succeed.

This was a case where the liquidators' primary claim failed at trial. An attempt was made to turn that into success by claiming investigation costs. That was rejected by the court, not only on the evidence and legal arguments but also because the court did not accept the directors' conduct had been wrongful. All of this emphasises the need for wrongful trading claims to be carefully considered. Office-holders and their lawyers should take note.

On the other hand, Snowden J's judgment also contains analysis as to how wrongful trading and other types of office-holder claim might be pleaded and proved to ensure success. The issues that were debated in this case are likely to arise in most wrongful trading claims. The opportunity to claim investigation and other liquidation costs has direct potential application to other office-holder claims such as preferences and transactions at an undervalue. The judgment thus provides office-holders and their lawyers with considerable opportunity for future development.

Christopher Boardman specialises in insolvency (including cross-border), commercial, fraud, company, partnership, banking and finance work. He previously worked as a derivatives trader and subsequently obtained a Masters in corporate and commercial law, therefore having practical experience as well as a sound financial and corporate background. In Ralls Builders Ltd, Christopher (and Christopher Lloyd at New Square Chambers) represented the respondents.

Interviewed by Kate Beaumont.

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