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UPDATE

Misfeasance claims by companies in liquidation: is a judgment debt an actionable loss?

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The recent BVI Court of Appeal decision in Stuart Mackellar (*as liquidator of Smart Plus International (Holdings Limited) v Khoo Kin Yong and others* BVIHCMAP 2013/0008, provides a useful review of the law relating to misfeasance and insolvent trading (sections 254 and 256 of the Insolvency Act, respectively).

Facts

The facts in this case are relatively straightforward. Smart Plus International (Holdings Limited) (**Smart Plus**), is a BVI incorporated company. The Respondents were all directors of Smart Plus.

Smart Plus never had any assets. Nevertheless, in 2001, one of its directors signed an agreement that it would invest up to £7.5m in a company called Coffee Bean Tea Leaf (**CBTL**).

That investment was never made. As a result, a director of CBTL commenced proceedings (personally) against the directors of Smart Plus (again, personally) in Singapore, for breach of the investment agreement.

In 2003, the parties agreed to stay the Singapore proceedings. Once again, Smart Plus entered into an investment agreement with CBTL. At that time, Smart Plus still had no assets. Under the terms of the stay, Smart Plus also agreed to pay £300,000 to CBTL. However, this sum was not paid and CBTL reinstated the Singapore proceedings.

Eventually, the Smart Plus directors successfully defended the Singapore proceedings on the basis that they could not be sued in their individual capacities for any breaches of the Investment Agreements by Smart Plus.

After this, CBTL commenced proceedings in the BVI against Smart Plus. CBTL eventually obtained judgment against Smart Plus for around £47m. When that sum was not paid, CBTL successfully applied for the appointment of a liquidator over Smart Plus (the **Liquidator**).

Liquidator's Claims against Directors of Smart Plus

Following his appointment, the Liquidator filed an application for relief against the directors under section 254 (misfeasance) and section 256 (insolvent trading) of the IA.

Section 254 Claim

Section 254 of the IA provides a summary procedure to make persons (including directors) liable to compensate a company in liquidation for misfeasance, or breach of fiduciary or other duties owed to the company.

For the purpose of this article, the key provisions of section 254 of the IA are as follows:

(1) On the application of the liquidator of a relevant company, the Court may make an order … where it is satisfied that a person specified in subsection (2):

  (a) has misapplied or retained … money or other assets of the company; or

  (b) has been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.

(2) …

(3) Where subsection (1) applies, the Court may make one or more of the following orders against the person:

  (a) …

  (b) that he pays to the company as compensation for the misfeasance or breach of duty such sum as the Court considers just; …

As the Court of Appeal noted in its judgment, section 254 does not create any new rights or obligations. It is a convenient alternative to the company bringing a legal claim against a specified person in its own name. Therefore, there needs to be both (a) a breach by that person of a duty he owed to the company and (b) loss.

In the present case, the Liquidator claimed that there had been misfeasance and/or negligence by the respondent directors. He alleged that, from the point the directors committed the company under the Investment Agreement, they knew that it would inevitably breach that contract and so be exposed to a claim by CBTL for damages for breach.

High Court Decision

At first instance, Bannister J dismissed the claim under section 254. He held that, before recovery could be made under section 254, it must be shown that the conduct complained of has depleted the company's assets. He held that the loss to which a director is liable, is loss which has caused damage to the company, eg he had either removed or diverted assets; or had negligently failed to protect assets when he should have done so.

Bannister J focused on the fact that Smart Plus had no assets from its inception. As such, there was never anything to be removed from or diverted from the company, and no loss had arisen. In reaching this conclusion, Bannister J held that the judgment debt was a liability; but this did not cause a loss within the meaning of section 254.

Court of Appeal Decision

On appeal, the Liquidator argued that the High Court had taken too narrow a view of what constituted a loss. He argued that loss had to be construed widely, to allow for an increase in liabilities as distinct from a diminution in assets. This, it was argued, was consistent with the fact that the balance sheet definition of insolvency as set out in section 8 of the IA is an excess of liabilities over assets.

The Court of Appeal first considered whether the directors breached any duty owed to Smart Plus. It noted the fiduciary duties owed by directors under section 120 of the BVI Business Companies Act 2004. It held that there was no evidence that the directors had breached any of those duties.

LJ in *Malcom Cohen et al v Grand Selby et al* [2002] BCC 82, the Court of Appeal observed that:

- there was no doubt that, under section 254, a liquidator could proceed where 'all that is alleged is common law negligence'; and
- to found a claim, 'the court has to be satisfied that the negligence has caused a loss in respect of which compensation can be awarded. The position, in this respect, is the same as it would be if the company had brought an action in its own name'.

In relation to the alleged breach of duty, the Court of Appeal rejected the Liquidator's assertion that the directors knew, from the point at which they committed Smart Plus to the Investment Agreement, that it would inevitably breach that contract. The Court rejected this allegation as being both illogical and unfounded on the facts. In doing so, the Court asked itself, 'why would the respondents … open themselves up to an application such as this one?'

The Court of Appeal then considered misfeasance and/or negligence. It noted that s.254 is analogous to s.212 of the UK Insolvency Act 1986. Relying on the dicta of Chadwick LJ in *Malcom Cohen et al v Grand Selby et al* [2002] BCC 82, the Court of Appeal observed that:

- there was no doubt that, under section 254, a liquidator could proceed where 'all that is alleged is common law negligence'; and
- to found a claim, 'the court has to be satisfied that the negligence has caused a loss in respect of which compensation can be awarded. The position, in this respect, is the same as it would be if the company had brought an action in its own name'.

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In relation to the alleged loss, the Court of Appeal reviewed a number of relevant decisions under section 212 of the English Insolvency Act 1986. Having done so, it upheld Bannister J's decision that Smart Plus had not suffered any loss, because it had no assets to begin with. Accordingly, the liability represented by the judgment debt did not amount to an actionable loss. In reaching this conclusion, the Court expressed itself in this way:

'Would Smart Plus have been able to bring a viable claim against the respondents for misfeasance and or breach of duty on the basis of a loss suffered? The answer, in my view, would be no, as Smart Plus never had in its balance sheet the sum awarded in the judgment which had been depleted and or misappropriated by the respondents.'

Section 256 Claim

For the purpose of this article, the key provisions of section 256 of the IA are as follows:

(1) On the application of the liquidator of a relevant company, the Court may make an order under subsection (2) against a person who is or has been a director of the company if it is satisfied that

  (a) at any time before the commencement of the liquidation 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

  (b) he was a director of the company at that time.

(2) Subject to subsection (3), where subsection (1) applies, the Court may order that the person concerned makes such contribution, if any, to the company's assets as the Court considers proper.

(3) The Court shall not make an order against a person under subsection (2) if it is satisfied that after he first knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, he took every step reasonably open to him to minimize the loss to the company's creditors …

In the present case, the Liquidator claimed that the company had incurred trading losses after the time at which the directors knew or ought to have concluded that there was no reasonable prospect that it would avoid going into insolvent liquidation.

High Court Decision

In relation to insolvent trading, Bannister J found that section 256 is designed to:

'… make directors who incur credit during a period when they ought to have realised that there was no chance that the company would avoid going into insolvent liquidation… make a contribution to the assets… so that the difference between the assets as they were when they ought to have appreciated that, as against the level of assets when the company finally … goes into liquidation … is made up.'

He found that the directors could not be made to pay money into the company either as a result of the breach of duty or the exception that is embodied in section 256.

Court of Appeal Decision

The Court of Appeal held that s.256 did not apply, because Smart Plus 'could not have been an insolvent company before a judgment was entered against it'. It had no assets or liabilities, and was therefore not insolvent. It had never traded at any point, therefore there was no period of loss experienced. The evidence before the High Court had been that Smart Plus intended to fulfil its contractual obligations. Therefore, in the Court's view:

'... a reasonably diligent person having the general knowledge, skill and experience of the respondents would not have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. There was no evidence presented at the lower court which would have led the judge to the inevitable conclusion that Smart Plus knew or ought to have known this.'

Conclusion

The Court of Appeal's decision is a helpful reminder of the relevant considerations liquidators must keep in mind when deciding whether to bring claims under sections 254 or 256 of the IA.

It also firmly establishes the principle that to succeed with a claim under section 254, the applicant must show a loss to the insolvent company caused by the breach of duty of the former officer. That is consistent with the purpose of section 254, as a mechanism by which others may litigate an insolvent company's cause of action, rather than a provision that creates a cause of action in its own right.

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