GUIDE

Insolvency claims in Guernsey

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Introduction

When a company enters into a formal insolvency process, the office holder will conduct an examination into the affairs of the company. This may lead them to suspect that the company's assets have been inappropriately diminished to the detriment of the general body of creditors.

Guernsey law provides a range of mechanisms that may be used to return assets to the company to maximise the value available for distribution.

This Guide will cover:

- misfeasance / breach of statutory duty
- wrongful trading
- fraudulent trading
- preferences
- transactions at undervalue
- extortionate credit transactions,
- director disqualification, and
- relief from sanctions.

Misfeasance / breach of statutory duty

Under section 422 of the Companies (Guernsey) Law, 2008 (the Companies Law), where it appears in the course of a winding up that a past or present officer of the company (including a director) or any other person directly or indirectly involved in the promotion, formation or management of the company has:

- appropriated or otherwise misapplied any of the company's assets
- become personally liable for any of the company's debts or liabilities, or
- otherwise been guilty of any misfeasance or breach of fiduciary duty in relation to the company

the company's liquidator or any creditor or member of the company may apply to the court for an order against that person personally.

Where a claim is successful, the court may order that the person repay or restore such money or property, contribute such sum to the company's assets and/or pay such interest as the court thinks fit, whether by way of indemnity or compensation or otherwise.

The potential conduct in respect of which a claim could be brought is wide-ranging. As breaches of fiduciary duties are covered by the provisions, it could include for example a director exercising their powers for improper purposes, not acting in good faith or not managing conflicts of interest. However, it has been held in Guernsey that the reference to 'misfeasance or breach of fiduciary duty' does not include a breach of a duty of care, so negligence by the directors would not alone give rise to a claim under section 422 (*Carlyle Capital Corporation Limited v Conway & Ors* (Royal Court, Unreported judgment, 38/2017 (*Carlyle*)).

Wrongful trading

The directors of a company in financial difficulty face additional burdens when looking to fulfil their duties to the company. While they must act *bona fide* in the best interests of the company, they are expected to have proper regard to the interests of its creditors. There are circumstances in which directors could be liable personally to contribute to any deficiency suffered by such creditors.

A director may incur personal liability for wrongful trading under section 434 of the Companies Law in circumstances where:

- the company has gone into insolvent liquidation, and
- at some time before the winding up of the company, the director (including a shadow director):
    - knew or ought to have concluded that there was no reasonable prospect of the company avoiding an insolvent liquidation, and
    - failed to take every step to minimise the potential loss to the company's creditors that that director ought reasonably to have taken.

What the director ought to have known is based on both their actual skill, general knowledge and experience and the skill, general knowledge and experience that may reasonably be expected of a person carrying out the same functions as that director in relation to the company, including any function which that director does not carry out but which has been entrusted to them.

In *Carlyle* it was alleged that the directors of the fund that had ultimately collapsed had committed wrongful trading. However Lieutenant-Bailiff Marshall, applying the provisions of the Companies Law's predecessor legislation (which were similar), found that the directors did not know and could not reasonably have known that there was no reasonable prospect of the company avoiding an insolvent liquidation. In particular, the Lieutenant-Bailiff noted the evidence showed that the financial markets could move very quickly and accordingly the directors could not know that the company was about to go insolvent until only a few days before it did.

An application for wrongful trading may be brought by the company's liquidator, a creditor or a member. If successful, the director may be ordered to make such contribution to the company's assets as the court thinks proper.

A director is not liable for wrongful trading if it can be shown that they took every step to minimise the potential loss to creditors that they ought to have taken. A director must take positive action to mitigate the potential loss to creditors - merely claiming that director had not done anything to cause any loss will not be a defence. Further, the action must be taken at the right time, ie when that director knew or ought to have concluded that there was no reasonable prospect of the company avoiding an insolvent liquidation. A director must neither act too late nor put the company into liquidation too early. Resigning on realisation that a company is facing financial difficulties will not be sufficient to protect a director.

Fraudulent trading

Unlike wrongful trading which incurs civil liability, fraudulent trading is also criminal offence under section 432 of the Companies Law. A person is guilty of fraudulent trading if they knowingly carry on the company's business with the intent to defraud creditors (whether of the company or of any other person) or for any fraudulent purpose.

The liquidator, administrator, administration manager or any creditor or member of the company may apply to the court for an order that the person restores or contributes to the company's assets.

For example, in England the courts have held that an offence is committed when directors continue to incur credit on their company's behalf without any reasonable expectation of funds being available to repay the debt when or shortly after it falls due.

Preferences

A preference is a transaction which improves a creditor's (or a surety or guarantor for any of the company's debts or other liabilities) position in the company's liquidation. Under section 424 of the Companies Law the court may set these transactions aside on the application of the liquidator if:

- the company was influenced in deciding to give a preference by a desire to bring about the improvement, and
- the transaction was entered into at a time when the company was unable to pay its debts (or became unable to do so as a result of the transaction).

A preference can be set aside if made at any time when the company was insolvent and in the six months prior to liquidation. This six-month period is extended to two years if the preference is made in favour of a 'connected person', eg a director. In that case, there is a presumption that the company was insolvent and influenced by a desire to improve the connected person's position in the event of a liquidation.

The relevant date to calculate the clawback period is the date of the application for the compulsory winding up of the company or the date that it passed a voluntary winding up resolution.

The court may make such order as it thinks fit for restoring the position to what it would have been if the company had not given the preference. That would include making an order setting aside the transaction or ordering that a third party transfer assets or pay a sum of money to the company. There are provisions protecting good faith purchasers for value who were not aware of the circumstances.

Transactions at undervalue

In insolvency proceedings commenced on or after 1 January 2023, liquidators and administrators have the statutory power to challenge transactions entered into at an undervalue. These provisions were introduced by The Companies (Guernsey) Law, 2008 (Insolvency) (Amendment) Ordinance, 2020 (the Ordinance) and are drafted in similar terms to the rules contained in section 238 of the UK Insolvency Act 1986.

Liquidators and administrators are able to apply to the Court to set aside a transaction if:

- it occurred within the last six months before the liquidation/administration, or two years where the other party to the transaction is connected to the company
- the company was insolvent at the date of the transaction or as a result of it, and
- it was not entered into in good faith for the purpose of carrying on the business of the company where there were reasonable grounds for believing that it would be of benefit to the company.

If the application is successful, the court may grant an order directing that the assets be restored to the company.

Creditors have the power to set aside transactions undervalue under Guernsey customary law and these powers may also be used by liquidators and administrators in insolvency proceedings commenced before 1 January 2023. A '*Pauline*' action may be used where a transaction was undertaken with the intention to defraud creditors and the company was insolvent at the time of or as a result of the transaction. If the transaction was undertaken for more than one purpose, it suffices that the intention to defraud was a substantial purpose.

The availability of this type of action in Guernsey was confirmed in *Flightlease Holdings (Guernsey) Limited & Ors v International Lease Finance Corporation* [2005-06] GLR Note 11, applying the principles set out in the Jersey case of *Re Esteem Settlement* 2002 JLR 53. It has been utilised more recently in *Batty v Bourse Trust Company Limited* [2017] GLR 54 where Deputy Bailiff McMahon (as he then was) observed that it is similar to the statutory relief available in the UK under section 238 of the Insolvency Act 1986.

A *Pauline* action may be used by any creditor of the company and, if successful, it operates to set aside the relevant transaction so that the assets in question are returned to the insolvent estate. It does not give rise to any entitlement to compensation from the debtor or any other person who was involved in the transaction.

Extortionate credit transactions

In addition, in insolvency proceedings commenced on or after 1 January 2023, under section 426E of the Companies Law liquidators and administrators have the ability to apply to the court to set aside extortionate credit transactions entered into in the last three years before the administration/liquidation.

A transaction would be regarded as extortionate if, having regard to the risk accepted by the person providing the credit, the terms required exorbitant payments or the transaction otherwise grossly contravened ordinary principles of fair dealing. Whether a transaction will meet this test is of course fact-specific.

Where a liquidator or administration brings an application to set aside this type of transaction, there is a presumption that the transaction was extortionate. This means that the person seeking to maintain the transaction would have the burden of proving that it was not.

Director disqualification

Under section 427 of the Companies Law, the court can impose a disqualification order on a person for up to 15 years preventing that person from being either a director, shadow director, secretary or other officer of any company (or any specified company) or from participating in or being in any way concerned in, directly or indirectly, the management, formation or promotion of any company.

To impose such an order, the court must be satisfied that a person's conduct in relation to a company or otherwise, makes them unfit to be concerned in the management of a company.

In insolvency proceedings commenced on or after 1 January 2023, liquidators and administrators are required under section 387A of the Companies Law to report 'delinquent' officers to the Guernsey Registry

and, in the case of regulated entities, to the Guernsey Financial Services Commission. A delinquent officer is any past or present officer of the company against whom there are grounds for the Royal Court to make a disqualification order. Insolvency rules provide for a standard form which should be used to make such a report.

Relief from sanctions

Section 522 of the Companies Law empowers the court to relieve a director of liability if in proceedings for negligence, default, breach of duty or breach of trust, it appears that the director has acted honestly and reasonably and that, having regard to all of the circumstances, they ought fairly to be excused for either wholly or partly from their liability.

Contacts

A full list of contacts specialising insolvency law can be found here.

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