

User Guide

Director's Representations, Fraud, Insolvency and Not So Limited Liability.

With the recession now in full swing and the Chancellor, Alistair Darling, admitting that his estimate of its duration and magnitude was significantly understated, the number of company and personal insolvencies are set to rise.

In the last quarter, company insolvencies in the Greater Manchester area alone; have increased by more than 38% when compared with the same quarter in 2007. In its most recent publication, the Insolvency Service reported a national increase of 51% in the number of compulsory liquidations and creditor's voluntary liquidations

as shown in the graph below.

Consequently, the protection of Directors autonomy and personal assets has become an increasingly salient consideration.

The supposed benefit of creating a limited company is that it affords the company's directors an umbrella of protection against

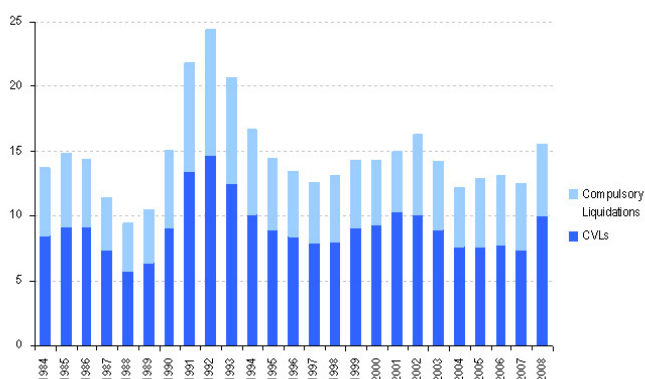
the liabilities that may attach themselves to the business, save for where personal guarantees are provided. Included within these liabilities is undoubtedly

the responsibility for settling the business' debts for payment of goods or services supplied to it. However, directors should consider the permeability of the protection afforded to them by their company's limited status in light of the increased risk of insolvency and the cases of *Contex Drouzbha Limited v Wiseman and Anor* and *Cheyne Finance Plc* (in receivership).

In *Contex Drouzbha*, Mr. Wiseman, in his capacity as a company director entered into and signed a contract for the supply of 300 items of men's clothing. It was a term of the contract that the company would make a future payment for these items. The court determined that, at the time of signing the agreement, Mr. Wiseman was acting as the mind of the company and knew that the company was effectively

Figure 3. Liquidations in England & Wales, 1984-2008

Thousands



Source: Insolvency Service and Companies House

insolvent and would not be able to meet the payment condition contained in the contract and likewise had no potential of ever being able to make the required payment. The court determined that the contract contained an implied representation that the company had the ability to pay for the goods ordered, and that by allowing the company to enter into the contract when he knew that it did not have the ability to pay for the goods, the director had made a fraudulent representation.

The court applied a previous House of Lords decision in the case of *Standard Chartered Bank v Pakistan National Shipping Corporation* and determined that due to Mr. Wiseman effectively being the mind of the company at the relevant time, he could be personally liable for his own fraud, such that the court found Mr. Wiseman to be personally liable (responsible), for damages in the tort of deceit.

The impact of this case is such that a director will not be able to hide behind a company's limited status to defend himself against claims damages in the tort of deceit if he has made either implied or expressed representations that the company is able to meet its payment obligations when he knows that it is not able to do so and is effectively insolvent.

The same risk also applies in situations where the director makes either implied or express representations and is aware of there being a possibility that the

company may become insolvent; albeit that the company may not actually be insolvent when the representation is made.

This situation could arise where the company takes on further credit to preserve the business whilst a long term remedy for cash flow problems is considered. A director may seek to rely on the fact that, at the time of entering an agreement for future payment, the company was not insolvent to avoid being liable for the tort of deceit. However, the case of *Cheyne Finance Plc* (in receivership) should be borne in mind. The case established that the test for insolvency under section 213 (1) (e) of the Insolvency Act 1986 does not preclude the consideration of future debts being considered when determining whether or not a company is insolvent and also clarified that the standard of proof for determining insolvency rests on the balance of probabilities. As such, if any contract entered into is likely to result in insolvency, the court will probably take the view that the company was insolvent at the time of entering into the contract and as such, the director may be deemed to have had knowledge of the insolvency and be adjudged to have made a misrepresentation as to the company's solvency and be personally liable.

A defence, however, may be available to a director who is pursued in the tort of deceit for misrepresentations made by him on behalf of the company. Section 6 of the Statute of

Frauds Amendment Act 1828, requires any misrepresentation made by the director about the company's ability to meet its payment obligations to have been made in writing and to have been signed by the director.

Also, *Contex Drouzbha* confirmed that a signature by the director in itself, will not automatically amount to a written representation being made. For example, in *Contex Drouzbha*, the director did not just sign an order form, rather he signed a framework agreement which contained provision as to how and when payment should be made and in doing so he was



deemed to have made an implied representation that the company could pay the fees due in accordance with the agreement which it transpired he knew it could not. The case also established that each case will depend on its own merits and circumstances.

Despite this, the case law has provided creditors with a useful opportunity to avoid the statutory red-tape that attaches itself to the Insolvency Act 1986. Under sections 213 and 214 of the Act, the liquidator has the power to make an application for

an order which forces the director (s) to make a personal contribution to the company's pool of assets, where a director carried out trade with the intention of defrauding creditors or where the director knew or ought to have known that the company would not be able to avoid becoming insolvent but, nonetheless, continued to trade. However, any contributions obtained from the director would go into the general pool of assets and would be divided between the various creditors. Whereas, any action for damages in the tort of deceit does not require the liquidator to act on behalf of the relevant creditor and likewise, if an award is made by the court, the same would not have to go in to the general pool of assets and likewise would not have to be divided between each creditor. As such, an action for damages in the tort against the director of a company may be a preferential option for an aggrieved creditor where a misrepresentation by a director has been made.

Following the case law developments and the increased likelihood of insolvency caused by the economic downturn, Directors should take especial care when entering into and signing any agreement where there is a chance that the company may become insolvent or where agreements are being entered into in the hope that they will delay insolvency or prevent it.

The information contained within this article is correct at the time of publication but should not be

relied on as a basis for pursuing an action against a director personally. The ability to successfully pursue a claim for damages in the tort of deceit and the likely chances of succeeding in any such claim will depend on the circumstances of each case and professional legal advice should be sought from us on both these points before making a claim.

If you would like any further advice on the context of this article or indeed would like advice on pursuing or defending an action against a director in relation to a company debt or advice on insolvency, please contact Pearson Hinchliffe Commercial Law's commercial litigation department on 0161-785-3500 or email us at enquiries@pearson-hinchliffe.co.uk.

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