Deepening Insolvency and the United Kingdom's Wrongful Trading Statute: A Comparative Discussion

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American courts continue to struggle with the concept of "deepening insolvency" and whether it is a viable additional claim that may be asserted in a company's bankruptcy. Although the courts have recognized the theory with increasing frequency in recent years, most notably the United States Court of Appeals for the Third Circuit, its contours remain ill-defined. It is not yet clear, for example, what quantum of misconduct is required to give rise to liability (which could range from outright fraud to a well-intentioned but foolhardy hope of saving a dying company), the various defenses that may be successfully interposed, or the reach of liability for deepening insolvency among the large pool of potential defendants.

In the United Kingdom, there has long been a statutory counterpart to what we are now recognizing as the deepening insolvency theory. This article of law is known as the "wrongful trading" statute. Under the wrongful trading statute, a court can impose liability on a company's directors where (1) the company is in insolvent liquidation, (2) at some time before commencement of the liquidation proceedings, the director knew or ought to have concluded that there was no reasonable prospect of avoiding the liquidation and (3) the court is not satisfied that the director thereafter took every step with a view to minimizing the potential loss to creditors that ought to have been taken. If found to have wrongfully traded under the statute, the court can order the director to pay to the company an amount of money the court, in its discretion,

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determines is appropriate. The court can also disqualify the director for a period of two to 15 years. Violating a disqualification order carries potential criminal liability.

The wrongful trading statute obviates some of the controversy and lack of definition that presently plague our deepening insolvency theory. The bankruptcy trustee's standing to act as a deepening insolvency plaintiff, for example, is a question not fully resolved, with some courts finding that the claims asserted actually belong to creditors. Under the Supreme Court's decision in Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972), the trustee is not permitted to assert creditors' claims, although some courts will allow the trustee to proceed as plaintiff if the claim is common among creditors. As Caplin instructs, Congress is free to do via an amendment to the Bankruptcy Code what the administrator of any insolvent estate is expressly conferred the authority and standing to do under the wrongful trading statute. Thus, in the U.K., the case can be made that legislation has dispensed with the need for the courts to wrestle with questions of claim ownership and whether the bankruptcy trustee is the proper party to prosecute the allegations asserted.

Similarly, the wrongful trading statute does not seem overly concerned with whether the directors owe a fiduciary duty to creditors because the company was at or near insolvency. To be sure, the wrongful trading statute requires that directors act in the interests of creditors, taking every step that ought to be taken to minimize creditors' potential loss. But liability for failing to take those steps does not appear to constitute a breach of duty; rather, the statute creates an exception to the general rule that directors are not personally liable for the corporation's debts. Thus, as with the standing issue, the wrongful trading statute resolves by its own terms an area of

conflict in American courts, which are not in agreement regarding when, if ever, directors owe creditors a fiduciary duty and, if so, what standard determines liability for a breach.

Another area of apparent divergence is the notion of fault, which seems to be rendered irrelevant under the wrongful trading statute. The statute simply looks to whether the company was insolvent and, if so, the conduct of the directors in relation to the company's creditors. Indeed, the wrongful trading statute coexists with the fraudulent trading statute, which imposes liability where a company's business was carried on with an intent to defraud creditors or other persons, or for any fraudulent purpose. Read together, the fraudulent and wrongful trading statutes bear a resemblance to § 548 of the Bankruptcy Code, which allows avoidance of transfers as fraudulent both where there is actual fraud and in the far more benign circumstance of insolvency and a lack of reasonably equivalent value for the suspect transfer.

By contrast, courts examining the deepening insolvency theory seem always to be in search of some wrongful conduct. In the leading case of Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340 (3d Cir. 2001), the court defined deepening insolvency by reference to fraudulent conduct and wrongful concealment of the company's troubled condition. More recently, another court undertook a review of a number of deepening insolvency cases and concluded that the prolongation of an insolvent company's life, without more, will not give rise to liability. Rather, "one seeking to recover for 'deepening insolvency' must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its

increased debt." Kittay v. Atlantic Bank of New York (In re Global Serv. Group, LLC), 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

This is not to say that merely prolonging an insolvent company's life is sufficient under the wrongful trading statute. What is additionally required, however, is not a separate tort or breach of some duty, as the Kittay court states, but the failure of the company's directors to take every step that ought to have been taken with a view to minimizing the potential loss to creditors.

Despite the differences, the wrongful trading statute and the deepening insolvency theory share a similar goal: Both attempt to undo some of the harm done to creditors once a company reaches insolvency and becomes unable to pay its debts. Moreover, both wrongful trading and deepening insolvency have the potential to reach well beyond a company's directors or, in the United States, officers and managers. Under the wrongful trading statute, again, the statutory language itself provides the basis for expanding the reach of liability because the statute expressly applies to "shadow directors."

A shadow director, as the name implies, is not formally a member of the company's board of directors. Rather, a shadow director can be defined as a person or entity that exerts control over the company because the directors have become accustomed to acting on the shadow director's directions or instructions. A shadow director can be deemed subject to the same liability that arises for the appointed board members. This includes liability under the wrongful trading statute and the threat of court-ordered director disqualification, which would preclude the person from participating in the formation, operation or liquidation of any incorporated business for a designated period of time.

With respect to the deepening insolvency theory, the shadow director concept is suggested in In re Exide Techs., 299 B.R. 792 (Bankr. D. Del. 2003), in which the court declined to dismiss a complaint alleging, among other things, that a syndicate of lenders structured its loans in a way that allowed the lenders to exercise significant control over Exide and its subsidiaries, and that, by continuing to fund Exide after it was insolvent, the lenders caused the company to fraudulently continue its operations at the expense of other creditors. Lender control over the debtor was at the heart of the Exide complaint, just as control would make a person a shadow director under the wrongful trading statute. Control also allows Exide to be distinguished from the Kittay decision, discussed above. Kittay also concerned a lender defendant, but the rule to be drawn from Kittay is that lending money to a troubled company is not enough, standing alone, to cross the threshold of imposing liability for deepening that company's insolvency.

The Kittay decision also raises an issue, common to the American insolvency practice experience, of which the wrongful trading statute seems to take no account, that is, whether liability will arise from a good faith, but unsuccessful, attempt to save a struggling company. The Kittay court correctly recollects that "chapter 11 is based on the accepted notion that a business is worth more to everyone alive than dead." Drawing a direct distinction to the wrongful trading statute, the Kittay court continued: "Thus, in contrast to the laws of some foreign jurisdictions, including the United Kingdom, there is no absolute duty under American law to shut down and liquidate an insolvent corporation. The fiduciaries may, consistent with

the business judgment rule, continue to operate the corporation's business." Kittay, 316 B.R. at 460.

In expressing the American preference for reorganization over liquidation, however, the Kittay court may have overstated the duty that arises under the wrongful trading statute. A recent decision from a U.K. court involving the directors of furniture retailer Uno and its wholly owned subsidiary, World of Leather, suggests that the duty to liquidate an insolvent company is not, in fact, absolute under English law; rather, directors may have some leeway in continuing to operate the company while undertaking an effort to save it.

Although Uno and World of Leather were retailers, they did not keep merchandise in stock. Instead, customers would pay a deposit at the time they placed their orders and the balance was paid upon delivery of the furniture. After becoming insolvent, the companies continued to take customers' orders and deposits, which were the key source of the companies' cash flow, and the directors argued this was done as part of an effort to save the companies and avoid insolvent liquidation.

The directors prevailed in the action and, as the authors of a discussion of the decision explained the court's reasoning:

> Key to his decision was the fact that the directors had relied on good financial information while continuing to accept customer deposits. Evidence showed that if the directors had ceased trading much earlier and placed the company into insolvent liquidation, the unsecured creditors – the customers who provided cash deposits but who had not yet received their goods – would have received nothing.
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> In addition, the judge commended the directors' decision to obtain full legal and professional advice before continuing to trade. With such advice in hand, they were able to assert that they believed that there was a reasonable prospect of

> finding a corporate solution, thereby achieving a satisfactory outcome for all of the group's creditors, not the least of which included its cash-paying customers.

Jamie White & Natalie Cropps, *Despite Uproar, Directors Escape Liability: U.K. Court Finds No Fault in Taking Deposits in Turnaround Try*, The Journal of Corporate Renewal, February 2005 at 6.

It must be noted that the Uno/World of Leather decision involved a director disqualification action, not one brought under the wrongful trading statute. But this fact does not diminish the importance of the case as embracing the notion that a good faith decision to attempt to turn a company around, based upon informed judgment made after consulting counsel and other professionals, is not necessarily worthy of punishment, but may, in fact, be a course of action to be encouraged. In this regard, the decision is not distinct from, but actually parallels, the sentiments expressed in Kittay.

Because much remains unclear regarding the application of the law of wrongful trading, and certainly that of deepening insolvency, it would be premature to make sweeping pronouncements about whether these doctrines are headed toward, or away from, each other in their development. Indeed, if the Uno/World of Leather case were brought in the United States, the very professionals that aided in the attempt to save the enterprise could have faced exposure as possible defendants in a deepening insolvency action. Their similarities and differences, however, remain important, as each could lend valuable clarification on the uncertain issues, especially those that arise for many professionals whose business is to save the troubled company.

Even though the concepts of deepening insolvency and wrongful trading originate on opposite sides of the Atlantic, we expect continuing informal convergence toward a common international theory of director and officer liability in coming years. We believe that judicial decisions on both sides of "the pond" related to these concepts will likely foster conditions under which an evolving thread of commonality in the future will lead to a more unified international approach to the potential assertion of these types of claims. With the growing trend to globalize our industry, one's awareness of the similarity of practices among nations can only work to our benefit as we watch the refinement of these practices in our own country.