NEW SQUARE CHAMBERS

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Company and Insolvency Newsletter

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This is the first issue of the New Square Chambers "Company and Insolvency Newsletter".

The Newsletter is intended to provide a quarterly commentary on selected recent developments in the fields of both Company and Insolvency law. We aim to make the Newsletter readable as well as useful, and we would welcome feed-back.

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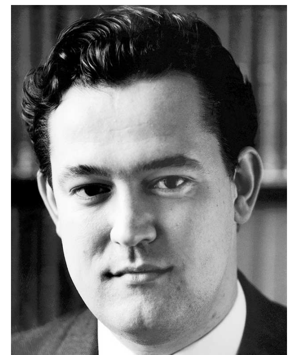
Watch out for the small print

Secured creditors who vote for an IVA can lose their security: *Khan v Permayer* [2001] BPIR 95 CA

Mark Hubbard



A recent case highlights a trap for secured creditors who vote in favour of an IVA.

If an IVA is approved a secured creditor is bound by its terms. But a secured creditor who does not vote in favour of an IVA proposal or otherwise consent to it cannot be prejudiced by the proposed terms.

The effect of an IVA proposal is essentially contractual. If secured creditors vote in favour of, or approve the proposal, the Court will construe the proposal as a contract to see if secured creditors have agreed to waive or modify their rights to enforce security.

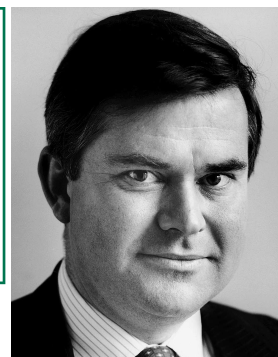
The facts of *Khan* are quite unusual and complicated. A more common scenario will be where a bank holds a charge over the debtor's property which is valued in the IVA at less than the full sum owed, with the balance being shown as unsecured. If the bank votes in favour of the proposal without insisting on modifications dealing with its rights to enforce its security it may well find it has limited the sum secured by its charge to the sum stated in the proposal even if the value of the property subsequently rises.

It would also seem to follow from *Khan* that if a debt is described as unsecured in the proposal and the creditor votes in favour, that creditor will not be able to claim afterwards that the debt is really secured.

Piercing the Corporate Veil

The House of Lords approves Prudential v. Newman Industries (No. 2)

Robin Hollington Q.C.



In this age of high expectations, people (and they may be good people) want to have their cake and eat it as well. Business people are no different. They find a limited company a very useful vehicle for carrying on business because it has a separate legal personality which is responsible for all the debts of the business. This fundamental principle of company law was established not by Parliament but by the courts in the celebrated case of *Salomon v. Salomon* [1897] AC 22. The separate legal personality of the company is obviously beneficial for the participants so far as concerns liabilities, but it can also prove tiresome for them so far as concerns assets. In particular, suppose the company or its business is damaged : does a shareholder have a cause of action, or is the company the sole proprietor of a cause of action? The fundamental general principle is that only the company has a cause of action.

There is one well-defined class of cases where a shareholder can bring an action where the company does not do so, but the significant feature of these cases is that the shareholder's action is brought for the benefit of the company, even though it is not initiated by the company. These shareholder actions are called derivative actions and are said to be the "exceptions to the rule in *Foss v. Harbottle*", because the rule in *Foss v. Harbottle* is to the effect that in general only the company can bring proceedings to enforce a wrong done to the company.

The "exceptions to the rule in *Foss v. Harbottle*" are not cases of a shareholder wanting to have his cake and eating it as well, because in such cases the shareholder is not questioning the separate legal personality of the company but merely using a special procedure to set the company's litigious wheels in motion.

Cases where the shareholder may be wanting to have his cake and eat it are those where the shareholder seeks to establish a personal cause of action vested in him. A prime example of this type of case is where the company is insolvent : the shareholder has a much reduced interest in enforcement of a cause of action by the company largely for the benefit of creditors, whereas he has every interest in obtaining recovery for himself personally. Not surprisingly, English courts have been fiercely resistant to increasingly sophisticated attempts by shareholders to pursue personal causes of action, the most recent and most authoritative example of which is the House of Lords decision in *Johnson v. Gore Wood & Co* [2001] 1 All E.R. 481.

It is essential first to have in mind the factual situations in which the problem commonly arises:

1. The sole shareholder and director of a company is run over by a bus, and the company's business suffers as a result: can he sue for the damage done to the company? Of course he can : the company has no cause of action, so that there is no breach of the fundamental principle. These were the facts of *Lee v. Sheard* [1956] 1 Q.B. 192.

   So it is clear that the shareholder can sue if the company has no cause of action.

2. The company suffers loss as a result of a breach of contract by a supplier: can a shareholder sue for the diminution in the value of his shareholding? Of course he should not be able to do so: no duty was owed to him by the supplier, so that he has no cause of action.

   So it is clear that the shareholder cannot sue if no wrong has been done to him personally.

3. A company (through its sole shareholder) goes to the solicitor who has acted in the past for both the company and the shareholder about a transaction involving the company, and due to the solicitor's negligence the company suffers loss. Can the shareholder sue?

This is the difficult area where the law has to decide what its general policy is to shareholder actions, because it may be necessary under other general principles of the law (the law of negligence, for example) to recognise that a duty is owed to the shareholder as well as the company - the question is whether the shareholder has suffered loss which he ought to be able to recover.

Quite apart from the hurdles of duty, causation and remoteness of damage that the shareholder must overcome like any other claimant, it has been held by the House of Lords in the *Johnson* case, following the earlier case in the Court of Appeal in *Prudential v. Newman Industries (No. 2)* [1982] Ch. 204, that the shareholder's claim will not be allowed if the loss claimed by him is "merely a reflection of the loss suffered by the company".

As the House of Lords explained, this principle is not a ritualistic application of doctrine but it is underpinned by important policy considerations, namely that there should not be double recovery in respect of the same loss and funds intended for the benefit of an insolvent company's creditors should not be diverted to the shareholders.

English law could have taken an alternative route more to

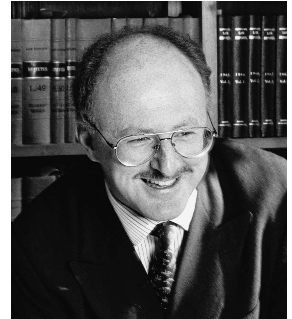
the liking of the shareholder who found the separate legal personality of the company inconvenient. The House of Lords disapproved of dicta in earlier Court of Appeal and Commonwealth decisions, where a more liberal view had been taken of the ability of a shareholder to recover loss connected with the company's loss. In particular, in *Christensen v. Scott* [1996] 1 N.Z.L.R. 273, the Court of Appeal of New Zealand held there was no rule of law that a shareholder cannot recover loss which is a reflection of the loss suffered by the company, but that it is up to the trial judge to protect against double recovery and diversion of assets to the prejudice of the company's creditors.

It is one thing, however, to state the general principle and quite another to apply it to the facts of a particular case. The speeches in *Johnson* are somewhat obscure on the practical aspect. In allowing many of the heads of damage to go to trial, the House of Lords pointed out the formidable difficulties faced by the shareholder in overcoming the difficulties of causation, remoteness of damage, and the *Prudential* principle.

The *Johnson* case is also now the leading authority on the vexed principle of res judicata / abuse of process, which finds its origins in the judgment of Sir James Wigram V-C in *Henderson v. Henderson* (1843) 3 Hare 100, 114: see *Friend v. C.A.A.* [2001] 4 All E.R. 385.

Lifting the Veil

Stephen Smith Q.C.



In what situations can the court lift or pierce the corporate veil or otherwise ignore the concept of limited liability, without statutory authority? There have been three recent first instance decisions, viz. *Gencor ACP Ltd v. Dalby* [2000] 2 BCLC 734, *Mubarak v. Mubarak* The Times 30 November 2000*, and Trustor v. Smallbone (No.2)* [2001] 1 WLR 1177.

As very many lawyers will have experienced, the concept of limited liability is a difficult one for clients to accept when the chips are down (the clients are in good company: even judges occasionally refuse to accept it). The clients object to the individuals they have throughout dealt with and who may over the years have taken large sums out of the relevant company, suddenly rejecting all responsibility for the discharge of the company's obligations.

Statute apart, are there any circumstances in which those individuals can be made liable on those obligations? The answer is yes, but they are very limited. The principal difficulty arises from the celebrated case of *Salomon v. Salomon & Co Ltd* [1897] AC 22.

The recent authorities were reviewed by the Vice-Chancellor in the *Trustor* case. In that case judgment for (the equivalent of) many millions of pounds had been obtained against an offshore company in respect of monies which had been misapplied by S, the managing director of a Swedish company. The judgment represented the monies of the Swedish company which had passed through the accounts of the offshore company, and was given on the basis that those sums were monies had and received by those companies (or received in the knowledge that they were trust monies). The question arose, could S, who was also the owner and controller of the offshore company, be held personally liable to repay all the monies which the company had been ordered to repay?

The answer was that he could: the Court was entitled to pierce the corporate veil and recognise the company's receipt as the receipt of the individual in control of the company if the company had been used as a device or a façade to conceal the true facts, thereby avoiding or concealing any liability of that individual.

The Court made clear, however, that it is not a sufficient justification to pierce the veil if the company has been engaged in some impropriety which was not linked to the use of the company structure to avoid or conceal liability. Nor was it sufficient that piercing the veil was said to be necessary in the interests of justice even though doing so would not prejudice the interests of third parties. An oft-cited remark to the contrary effect from a judgment in the Court of Appeal in *Re a Company* [1985] BCLC 333 was disapproved.

Although the *Trustor* decision is to be welcomed on its particular facts, the reconciliation of the perceived differences in approach in the two divisions of the High Court where the issue most often surfaces (Chancery and Family) is still awaited. The suggestion of Bodey J, in the *Mubarak* case was that there ought not to be any difference in principle in the approach.

Also not dealt with in the Vice-Chancellor's decision is the suggestion in the Court of Appeal decision in *Adams v. Cape Industries plc* [1990] Ch 433 (at p. 543 F-G) that the corporate veil might indeed be ignored in a case where it was obviously a façade, without the necessity of showing impropriety. Intriguingly, however, the Vice-Chancellor did acknowledge that the first proposition advanced by the Claimant, viz. that the corporate veil could be pierced "where the company was shown to be a façade or sham with no unconnected third party involved" was "plainly established" on the authorities.

Accessory Liability: The "New" Dishonesty

The Lords decides *Twinsectra Ltd v Yardley & Ors.*

Claire Staddon

When a director has diverted company money for an improper purpose Claimants often end up pursuing third parties who have assisted the director along the way but without having received the funds themselves for their own use and benefit.

The House of Lords in *Twinsectra Ltd v Yardley & Ors.* [2002] 2 WLR 802 has examined the necessary standard for the test of dishonesty for the third party's liability as an accessory to a breach of trust or breach of fiduciary duty.

In *Twinsectra* a solicitor was found at first instance to have shut his eyes to problems with or implications of dealing with what was held to be trust money, yet the first instance judge found him not to have been dishonest. The Court of Appeal substituted their own finding of dishonesty. The House of Lords restored the judge's finding. Their lordships accepted that an accessory's deliberate abstinence from inquiry in order to avoid certain knowledge of what he suspected to be the case might well indicate ("Nelsonian") dishonesty, but contrary to the phraseology of parts of the first instance judgment, that was held not to be the factual situation in *Twinsectra.*

In *Royal Brunei Airlines v Tan* [1995] 2 A.C. 378 the Privy Council had already rejected "knowing assistance" as the test in favour of "dishonest assistance". Dishonesty was said to mean simply not acting as an honest person would in the circumstances. From the words of Lord Nicholls, the standard appeared to a number of subsequent Courts, commentators and practitioners to be almost entirely objective:

> "honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another's property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour".

Now in *Twinsectra* (Lord Millett dissenting on this aspect), the *Royal Brunei Airlines v Tan* test is explained and followed. The test of "dishonest" rather than "knowing" assistance is correct. The test for dishonesty is however not in fact a purely objective test: that would be "less than just". Instead it is a combined test of partly objective and partly subjective elements:

- the conduct was objectively dishonest; and

- the accessory was conscious that his conduct was dishonest according to the ordinary standards of reasonable and honest people: even if he set his own standards of honesty, and did not regard as dishonest what he knew would offend the normally accepted standards of honest conduct (the "Robin Hood test").

From now on therefore practitioners seeking to pursue the proceeds of a director's misappropriation of company funds will need to place more emphasis in pleading and cross-examination upon the accessory's knowledge that his conduct was dishonest by ordinary standards.

For the future, Lord Millett who gives a strong dissenting judgment on the accessory liability aspect of *Twinsectra*, indicates that the other branch of this area of law, knowing receipt, itself awaits a much-needed rationalisation.

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