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BEHIND THE VEIL

Some Remedies Available to an Unsecured Creditor

1. When an unsecured creditor (or a secured creditor who does not have a first or priority status) has an insolvent company as a debtor, its options usually appear to be very limited. When the company's debts exceed their known assets, unsecured creditors often conclude that the choice is between writing off their debts or instituting winding up proceedings with a view to accepting a few cents on the dollar[1]. This paper will attempt to give a brief overview of other possible options.

2. The authorities indicate that a creditor in that position may have other options. It may be able to show that it is not a general creditor of the company, but the beneficiary under a trust and thereby in effect, entitled to payment in priority to even secured creditors. Alternatively, the creditor may be able to claim against the directors or other third parties personally although they have not guaranteed the debt. The options which I will consider in this paper can be categorized under the following headings.

   A. Trust

   B. Directors' liability for trading while insolvent

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1 Companies Act, Ss 203(e) and 204(a) sets out the bases on which a creditor can institute proceedings to wind up a debtor company

C. Third Party Mareva Injunctions

D. Unjust Enrichment/Restitution

A. **Trust**

3. The circumstances in which the debt is created may give rise to a trust, and may entitle the creditor to trace its funds into the debtor's hands. In those circumstances, the creditor/beneficiary, will be able to claim those funds in priority to any other creditors or the company. In fact, there have been a number of cases in which the Courts have allowed the creditor to recover the money from a third party who received those funds innocently and for good consideration, but with knowledge of the circumstances which gave rise to the trust. An example of such a case is the decision of the House of Lords in **Barclays Bank Limited v Quistclose Investments Limited** [2].

4. In the **Quistclose** case, Quistclose lent a sum of money to a company for the purpose of paying dividends to its shareholders, and the funds were paid in to the company's bank. The bank knew that the funds were on loan to the company for the specific purpose of paying dividends. The company went into voluntary liquidation before the dividend was paid and while the company was heavily indebted to the bank. The bank applied the funds against the company's debts. Quistclose brought

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2 [1968] 3 All ER 651

an action for recovery of the money from the bank. The House of Lords held that the bank held the funds on a resulting trust for Quistclose and that Quistclose was entitled to recover the money, in priority to all the company's creditors, including the bank.

5. At page 654 of the judgment, Lord Wilberforce defined the issues:

> *"Two questions arise, both of which must be answered favourably to [Quistclose] if they are to recover the money from the [bank]. The first is whether as between [Quistclose] and [the Company] the terms on which the loan was made were such as to impress on [the funds] a trust in their favour in the event of the dividend not being paid. The second is whether, in that event, the [bank] had such notice of the trust or the circumstances giving rise to it as to make the trust binding on them."*

6. Lord Wilberforce continued:

> *"There is no doubt that the loan was made specifically in order to enable [the company] to pay the dividend,... and for no other purpose... The mutual intention of [Quistclose and of the company] and the essence of the bargain was that the sum advanced should not become part of the assets [of the company], but should be used exclusively for payment of a particular class of its creditors, namely, those entitled to the dividend."*

7. It should be noted that there was no express trust nor pre-existing fiduciary relationship between the parties. Indeed, the bank complained that this was merely

a routine commercial loan, although made (as most loans are) for a specific purpose. The House of Lords held, however, that that was sufficient to create a trust, and that since the bank was aware of the purposes for which the funds were lent, it held the funds on a resulting trust for Quistclose, unless and until the dividend was paid. It should also be noted that in **Quistclose**, the money had been mixed with other funds and was not in a segregated account. That did not prevent the finding that it was nonetheless subject to a trust.

8. England's Court of Appeal recently made a similar ruling in an interesting case. In **Boscawen and others v Bajwa and another**[3], Mr Bajwa owned a property and charged it in favour of Halifax Building Society. He entered into an agreement to sell the property and the purchaser obtained a loan from the Abbey National Bank. The loan was to be secured by a charge on the property. The bank sent part of the purchase price to the purchaser's attorneys who paid it over to the building society. The building society discharged the mortgage. The sale was never completed.

9. The Court of Appeal held that until the sale was completed, the money belonged to the bank and Mr Bajwa could not claim or properly receive, the benefit of it. The bank was entitled to trace its money into the vendor's account, and since the mortgage had been discharged, to be subrogated to the building society's rights

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[3] [1995] 4 All ER 769

under the mortgage and thereby become an equitable mortgagee. Millet L J, (as he then was), wrote the leading judgment of the Court. At page 784 he said:

> *"Abbey National's right to be subrogated to the Halifax' charge... arose at the very moment that the Halifax' charge was discharged in whole or in part with the Abbey National's money. It arose because having regard to the circumstances in which the Halifax' charge was discharged, it would have been unconscionable for Mr Bajwa to assert that it had been discharged for his benefit. At law, Mr Bajwa became the owner of an unencumbered free hold interest in the property; but he never did, even for an instant in equity."*

10. Millet L J also commented on the various remedies which may be open to a creditor in these circumstances. He said at page 777:

> *"If the plaintiff succeeds in tracing his property, whether in its original or in some changed form, into the hands of the defendant and overcomes any defences which are put forward on the defendant's behalf, he is entitled to a remedy. The remedy will be fashioned to the circumstances. The plaintiff will generally be entitled to a personal remedy; if he seeks a proprietary remedy he must usually prove that the property to which he lays claim is still in the ownership of the defendant. If he succeeds in doing this, the court will treat the defendant as holding the property on a constructive trust for the plaintiff and will order the defendant to transfer it in specie to the plaintiff. But this is only one of the proprietary remedies which is available to a court of equity. If the plaintiff's money has been applied by the defendant, for example, not in the acquisition of a landed property but in its improvement, then the court may treat the land as charged with the payment to the plaintiff*

of a sum representing the amount by which the value of the defendant's land has been enhanced by the use of the plaintiff's money. And if the plaintiff's money has been used to discharge a mortgage on the defendant's land, then the court may achieve a similar result by treating the land as subject to a charge by way of subrogation in favour of the plaintiff."

11. Plaintiffs in subsequent cases have tried to extend the principle to circumstances where the property being claimed was not originally the subject of a trust, but where the Courts are being asked to declare a trust as part of a restitutionary remedy. The Courts have made a distinction between an "institutional constructive trust" as was present in **Quistclose**, and a "remedial constructive trust." In another decision of the House of Lords **Westdeutsche Landesbank Girozentrale v Islington London BC**[4], Lord Browne-Wilkinson explained the distinction in the following way:

> *"Under an institutional constructive trust, the trust arises by operation of law as from the date of the circumstances which give rise to it: the function of the court is merely to declare that such trust has arisen in the past. The consequences that flow from such trust having arisen (including the possibly unfair consequences to third parties who in the interim have received the trust property) are also determined by rules of law, not under a discretion. A remedial constructive trust, as I understand it, is different. It is a judicial remedy giving rise to an enforceable equitable obligation: the extent to which it operates retrospectively to the prejudice of third parties lies in the discretion of the court."*

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4 [1996] 2 All ER 961 at 997

12. Subsequent cases have embraced the former type of trust, but cast doubts on the latter. In fact, in a recent decision of England's Court of Appeal (**Re Polly Peck International plc (in administration) (No. 2)**[5]) the applications sought an order that funds in the hands of an insolvent company, which was in administration, were subject to a "remedial constructive trust." Mummery LJ observed that the result of such a holding would be to "exclude those assets from pari passu distribution... among the unsecured creditors in the company,"[6] and concluded that "the prospect of a court imposing such a trust is inconceivable."[7]

13. It is important to note, however, that the applicant in that case could not claim that the circumstances disclosed a trust from the beginning. The Court in effect recognised that whereas in **Quistclose** or **Boscawen** circumstances were such as to support a claim that there was an "institutional constructive trust" all along, no such circumstances were present in **Polly Peck**. If they were, the result would no doubt have been otherwise.

14. The question which inevitably arises is how far the **Quistclose** principle should be extended. If a lender can recover his money from an insolvent company in priority

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5 [1998] 3 All ER 812

6 ibid, p 822 h

7 ibid, p 827 g

to other creditors on the basis that it was lent for a specific purpose which was not fulfilled, why should a purchaser of goods not also be able to do so? He also can claim that he paid the purchase price for a specific purpose, (i.e., receiving the goods in exchange) which purpose has not been fulfilled.

15. That argument was attempted in **Re Goldcorp Exchange Ltd. (in receivership)**.[8] In that case, the respondents purchased gold bullion which was to be delivered at a future date. The bullion that was to be delivered to the respondents was not identified or set aside, but formed part of the company's overall stock of bullion. Before delivering the bullion to the respondents, the company became hopelessly insolvent, and the appellant bank appointed receivers pursuant to a debenture. The debt due to the bank exceeded all the assets of the company including the stocks of bullion, and the bank's floating charge crystallised upon the appointment of the receivers. The respondents instituted proceedings claiming that they were entitled to recover pursuant to a trust, either on the basis that some of the bullion was held on trust for them, or that the company held the purchase price in trust for them pending delivery of the goods.

16. On appeal to the Judicial Committee of the Privy Council from the Court of Appeal of New Zealand, both contentions were rejected. The Privy Council held that the

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8 [1994] 2 All ER 806

buyer could not have obtained an equitable title in the goods since at the time of the sale, (and indeed at the time of the receivership), they were still unascertained, and the buyer could not acquire title until it had been determined to what specific goods the title would relate. More importantly for our purposes, however, the Privy Council held that on the facts of the case, there was no trust in favour of the respondents in relation to the money paid by them, since there was no mutual intention that the money would not fall within the general fund of the company's assets, or that it would be applied for a special designated purpose. Their Lordships agreed that there could be a trust in relation to money paid under a contract for the sale of goods. Lord Mustill, who delivered the opinion of the Board, said at page 823:

> *"That a sum of money paid by the purchaser under a contract for the sale of goods is capable in principle of being the subject of a trust in the hands of the vendor is clear. For this purpose it is necessary to show either a mutual intention that the monies should not fall within the general fund of the company's assets, but should be applied for a special designated purpose or that having originally been paid over without restriction, the recipient has later constituted himself a trustee of the money."*

17. Lord Mustill felt that this was a necessary extension of the decision in **Quistclose** and cited **Re Kayford Limited**[9] as a case in which these requirements were satisfied. In **Kayford**, the company carried on a mail order business and customers either paid the full purchase price or a deposit when ordering goods. The company

9 [1975] 1 All ER 604

fell into financial difficulties and was concerned about protecting customers in the event of its insolvency. It therefore started placing deposits into a separate bank account pending delivery of the goods. Megarry J held that in those circumstances, a trust had been created, and purchasers could recover in priority to other creditors.

18. The Board in **Goldcorp**, approved of the decision by Megarry J, but distinguished it from the case before them. Lord Mustill continued on page 824:

> *"The facts of the present case are, however, inconsistent with any such trust. This is not a situation where the customer engaged the company as agent to purchase bullion on his or her behalf, with immediate payment to put the agent in funds, delivery being postponed to suit the customer's convenience. The agreement was for a sale by the company to, and not the purchase by the company for, the customer. The latter paid the purchase price for one purpose alone, namely to perform his side of the bargain under which he would in due course be entitled to obtain delivery. True, another part of the consideration for the payment was the collateral promise to maintain separate cover, but this does not mean that the money was paid for the purpose of purchasing gold, either to create separate stock or for any other reason. There was nothing in the express agreement to require, and nothing in their Lordships' view can be implied, which constrained in any way, the company's freedom to spend the purchase money as it chose, or to establish the stock from any source and with any funds as it thought fit."*

19. Lord Mustill went on to say that the respondents had a further difficulty. At page 827

he added:

> *"This makes it unnecessary to consider whether if such an interest had existed it would have been possible to trace from the subject matter of the interest into the company's present assets. Indeed, it would be unprofitable to do so without a clear understanding of when and how the equitable interest arose and of its nature. Their Lordships should, however, say that they find it difficult to understand how the judgment of the Board in* ***Space Investments Limited v Canadian Imperial Bank of Commerce Trust Co. (Bahamas) Limited and others***[10] *on which the respondents leaned heavily in argument would enable them to overcome the difficulty that the monies said to be impressed with the trust were paid into an overdrawn account and thereupon ceased to exit."*

20. It is perhaps fortunate that this last observation by Lord Mustill was obiter. In my respectful opinion, that statement is not only contrary to principle, but it would contradict the decision of the House of Lords' in **Quistclose**. When money is paid into an overdraft account, it does not "cease to exist." It is appropriated by the bank and set off against the debt due to it. That is, in fact, exactly what Barclays Bank did in the **Quistclose** case, and the House of Lords held that Quistclose could nonetheless trace the funds and enforce the trust against the bank, the bank having had notice of the circumstances in which Quistclose lent the money. A recipient of trust funds cannot use the money for some other purpose, and thereby defeat the

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10 [1986] 3 All ER 75

trust, and if that recipient is a bank, it could not apply the funds against the balance in an overdrawn account and contend that the funds have "ceased to exist."

21. Lord Mustill concluded by observing at page 832 that "the law relating to the creation and tracing of equitable proprietary interests is still in a state of development." That statement is probably still true today, but the following can be stated with some confidence:

a. The test is whether there was a mutual intention that the monies should not fall within the general funds of the company. That intention may be expressly stated in the agreement between the parties.

b. Such an intention will be implied when the company was not intended to be the ultimate recipient of the monies, for example, where the company is an agent of the person paying the funds or where the company was to pay the funds to someone else such as a supplier of goods.

c. Such an intention may also be implied from the unilateral conduct of the recipient of the funds such as by its putting the funds into a separate account as in the **Kayford** case.

d. The trust can be enforced against a third party who has received the funds if it has done so with notice of the circumstances. The third party need not have express notice of the trust as long as it knows of the circumstances which give rise to the trust. This notice need not come from the settlor or

beneficiary of the trust.

B. Directors' liability for trading while insolvent

22. The **Companies Act** ("the Act") provides[11]:

*(1) "**If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company** or creditors of any other person or for any fraudulent purpose, **the Court**, on the application of the Trustee, or the liquidator or any creditor or contributory of the company, **may**, if it thinks proper so to do, **declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.***

On the hearing of an application under this subsection the Trustee or the liquidator, as the case may be, may himself give evidence or call witnesses.

(2) Where the Court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration, and in particular may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him , or on any mortgage or charge or any interest

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11 Section 305

in any mortgage or charge on any assets of the company held by or vested in him, or any company or person on his behalf, or any person claiming as assignee from or through the person liable or any company or person acting on his behalf, and may from time to time make such further order as may be necessary for the purpose of enforcing any charge imposed under this subsection.

For the purpose of this subsection, the expression "assignee" includes any person to whom or in whose favour, by the directions of the person liable, the debt, obligation, mortgage or charge was created, issued or transferred or the interest created, but does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any of the matters on the ground of which the declaration is made.

(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in sub-section (1), every person who was knowingly a party to the carrying on of the business in manner aforesaid, shall be liable on conviction on indictment to imprisonment with or without hard labour for a term not exceeding two (2) years or to a fine not exceeding $1,000 dollars or to both such imprisonment and fine.

(4) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made, and where the declaration under sub-section (1) is made in the case of a winding up, the declaration

shall be deemed to be a final judgment within the meaning of paragraph (h) of section 19 of the ***Bankruptcy Act**."*

23. The section therefore creates civil liability (section 305 (1)) and criminal liability (section 305 (3)) against persons who were knowingly parties to the carrying on of the business in such circumstances. By virtue of s.305(4) of the Act, the declaration is a final judgment under s.19(h) of the **Bankruptcy Act** and therefore steps can be taken to realise the assets of the directors after a declaration is made. It should be noted that not only directors are subject to liability under this section. Managers and other officers may be liable also (see **Re Maidstone Buildings Provisions Ltd.**[12]). The equivalent to our section 305 is section 322 of the **Companies Act** 1948 in England. The issue of whether or not a company must be wound up or be in the process of being wound up before an action can be commenced under section 322 was considered by the House of Lords in **R v. Schildkamp.**[13] At page 22 Lord Upjohn said:

> *"Of course, the fraudulent trading must take place while the company is a going concern and the whole question is whether before any person can be prosecuted for the commission of an offence under subsection (3) the company referred to must subsequently have been put into liquidation, which admittedly is not the case here."*

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12 [1971] 3 All ER 363

13 [1971] AC 1

24. The learned Judge continued at page 24:

> *"I see much to be said for the view that subsection (3) is limited to prosecutions after the commencement of a winding up. Subsection (1) which creates a new civil liability for fraudulent trading before winding up is clearly so limited. I find it almost impossible to suppose that if Parliament intended to create a criminal liability while the company was a going concern it would not have imposed a civil liability at the same time. Of course, a fraudulent trader might be made civilly and criminally liable if his fraudulent trading fell within some well-known category, for example, obtaining money or goods by fraud. But this is a very wide and vague new offence. If it was intended that subsection (3) was to be of general application while the company was a going concern, I should expect to find the subsection clearly so expressed. Then in the absence of such expressed words where you find subsection (3) joined by its opening words to subsection (1) I should be inclined to think that the draftsman had been careless in drafting and was not intending to create a new and quite independent liability. If the appellant's argument to the effect that to limit the effect of subsection (3) to prosecutions after the commencement of the winding up you must virtually rewrite the subsection was correct, I should see much force in his argument, for it would be very difficult to rewrite the subsection so that in grammatical terms you confined it to prosecutions after winding up, but I do not think that this is necessary for reasons which I will give later."*

25. A company must therefore be in the course of being wound up before steps can be

taken to rely on either section 305 (1) or section 305 (3) of the Act.

26. The issue of whether or not mere knowledge of the insolvency of a company and continuing to trade with that knowledge is sufficient to form the basis for an action under Section 305 (1) or a prosecution under section 305 (3) has been the subject of much dispute before the courts. In an early decision, **Re William C. Leitch Bros. Ltd.**[14], Maugham J. took the position that an intent to defraud creditors can usually properly be inferred if the company continues to carry on business and incur debts when to the knowledge of the directors, there is no reasonable prospect of those debts being paid. In **Re Patrick and Lyon Ltd.**[15] however, the same judge had this to say:

> *"...I will express the opinion that the word "defraud" and "fraudulent purpose" where they appear in the section in question, are words which connote actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame. No judge, I think, has ever been willing to define "fraud", and I am attempting no definition. I am merely stating what in my opinion, must be one of the elements of the word as used in this section."*[16]

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14 [1932] 2 Ch 71

15 [1933], Ch 786

16 ibid at p 790

27. It appears that the judge took a stricter approach to the test of what constitutes "intent to defraud" in the **Re Patrick and Lyon** case. Interestingly, in the **Re William** decision in determining the extent of the director's liability to the creditors, the judge took the position that this was a matter within the discretion of the Court. The judge made a declaration that the director was personally liable without any limitation on his liability for the sum due to the creditors of the company. Maugham J's approach in the **Patrick & Lyon** case was approved as recently as 1990 in **Re L Todd (Swanscombe) Ltd.**[17]

28. In a more recent decision, **Re Gerald Cooper Chemicals**[18] in discussing whether or not fraud was committed by a company carrying on the business of selling indigo, Templeman J said at page 53.

> *"In my judgment, they carried on that business with intent to defraud creditors if they accepted deposits knowing that they could not supply the indigo and were insolvent. They were carrying on business with the intent to defraud creditors as soon as they accepted one deposit knowing that they could not supply the indigo and would not repay the deposit. It does not matter for the purposes of S. 332 that only one creditor was defrauded, and by one transaction, provided that the transaction can properly be described as a fraud on a creditor perpetrated in the course of carrying on business. If the Cooper company had fraudulently supplied sub-standard indigo to*

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17 [1990] BCLC 109

18 [1978] 2All ER 49

Harrisons, the Cooper company would have committed a fraud on a customer, but by accepting a deposit knowing that they could not or would not supply indigo, and by using the deposit in a way which made it impossible for them to repay Harrisons, the Cooper company, in my judgment, committed a fraud on a creditor. If a mail order company advertises goods and solicits deposits with no intention of supplying the goods or of returning the money or if one hundred customers in response to the advertisement pay over £100,000 the business of the company is plainly being carried on with intent to defraud creditors of the company. If the company, as in the present case, solicits and obtains an advance of £100,000 from one customer the situation is no different. It follows that if the points of claim are substantiated, the Cooper company was being carried on with the intent to defraud creditors within the meaning of s. 332."

29. In **R. v. Grantham**,[19] after reviewing the **William C Leitch** decision, the **Re Patrick and Lyon** decision and the facts of that case, the Court of Appeal held that it is not necessary to prove knowledge that there was no reasonable prospect of the debts ever being paid; proof of knowledge that there was no reason for thinking that funds would become available to pay the debt when it became due or shortly thereafter may be sufficient. This case related to a criminal prosecution under section 322 (3) of the **Companies Act** 1948, and the Court of Appeal was approving the trial Judges summing up. The fact that the burden of proof is higher for a prosecution under that section than for a civil action under s. 305(1) may make this an even

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19 [1984]2 WLR 815

stronger case.

30. In **Re a Company (No 001418 of 1988)**,[20] the Court relied on **the Grantham** decision and confirmed the legal position to be as follows:

> *"A person was knowingly party to the business of a company having been carried on with intent to defraud creditors if (a) at the time when debts were incurred by the company he had no good reason for thinking that funds would be available to pay those debts when they became due or shortly thereafter and (b) there was dishonesty involving real moral blame according to the current notions of fair trading." (emphasis ours)*

31. The judge urged that caution be applied in determining the state of a director's mind at the time when the company was going through financial difficulties since the "risk of unfairness through hindsight needs to be borne in mind". After reviewing the company's profit and loss status over a six years period and the auditor's reports of the company, the judge indicated that there were clear warnings to the defendant that the continuation of the company's activities depended on its ability to maintain its profitability among other things. The remuneration of the directors was also examined. In this regard, the judge said at page 202:

> *"In my judgment the amounts of remuneration were very high for a company in such a state. For the year ended 31 March 1983 the remuneration was*

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20 (1991) BCLC 197

£35,000. That was the year of the substantial profit and I see the case that that might well have been justified. However, for the following year, to 31 March 1984, the remuneration package increased to £37,521. That was the year where there was a sharp swing to loss and a large adverse change in the net assets position. .... I ask theoretically: What were the directors doing paying themselves these significant and increasing sums while the debts to the company's creditors mounted?"

32. The fact that directors continue to carry on business knowing that the company is insolvent does not necessarily amount to "fraudulent trading". This however provides a presumption of the director's intentions especially if conducted over a prolonged period of time and if it is obvious that the company cannot repay its debts. The salaries which the directors received in the face of the continuing financial difficulties of the company is also a factor which it appears the court will take into account in considering whether there was an intent to defraud by the directors.

33. The following should also be noted. The mere status of being a director of a company does not ipso facto mean that that person had full knowledge of all the company's transactions; he must have knowledge of the particular transaction relied on: **Rossleigh Ltd. v Carlaw and Carlaw**.[21] Also, it is necessary to show an act which could be described as carrying on the business of the company: **Re**

[21] (1985) 1 BCC 99, 537, Ct of Sess

Augustus Barnett & Son Ltd.[22] In that case, then Chancery Judge Hoffmann J, held that the issue of letters of comfort by a parent company did not constitute the carrying on of the subsidiary's business.

TO WHOM WOULD THE DIRECTORS BE LIABLE?

34. Section 305 (1) of the Act clearly indicates that a liquidator or the creditors of the company can bring an action against the directors. In discussing an application by creditors under Section 322 (1) of the Companies Act 1948, in the decision of **Re Cyona Distributors Limited**,[23] Lord Denning MR had this to say:

> *"An order can be made either at the suit of the liquidator, etc. or of a creditor. The sum may be compensatory; or it may be punitive. The court has full power to direct its destination. The words are quite general: "all or any of the debts or other liabilities of the company as the court shall direct." By virtue of these words the court can order the sum to go in discharge of the debt of any particular creditor: or that it shall go to a particular class of creditors: or to the liquidator so as to go into the general assets of the company: so long as it does not exceed the total of the debts or liabilities. Of course, when an application is made by a liquidator the court would usually order the sum to go in to the general assets as Eve, J did in re Williams v. Leitch Brothers., Ltd: but I do not think that it is bound to do so.*

22 [1986] BCLC 170

23 [1967] 1 All ER 281

Certainly, when an application is made by a creditor who has been defrauded, the court has power, I think, to order the sum to be paid to that creditor. In short, I think that the words of the section are to be given their full width. When a creditor applies, as the commissioners did here, he applies on his own account. He does not apply as being under a trust for the other creditors or for anyone else. He is the master of his own application. He can discontinue his application, if he likes, without getting the sanction of the liquidator. No doubt however, the liquidator should always be made a party to the proceedings so that the interest of the other creditors can be safe guarded."[24]

35. A liquidator or creditors of the company are therefore entitled to rely on the section and bring a claim against directors. There is an advantage to the claim being brought by a creditor since there is no uncertainty as to whether the creditor is able to pay himself directly (without regard to other creditors or the liquidator) from any funds which may be realized as a result of obtaining a declaration under the section.

36. It however appears that if the application is brought by a liquidator, the liquidator may need to pay funds into the general assets of the company and this will therefore be subject to distribution among all of the creditors of the company.

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24 ibid, p 284

37. **R v Smith**[25] a decision of England's Court of Appeal, related to the prosecution of the chairman of a merchant bank who was also the managing director. The managing director who controlled the merchant bank, Wallace Smith Trust Co. also controlled other companies based in Canada including Wallace Smith Holdings. The case addressed the meaning of the word "creditor" in section 458 of the **Companies Act** 1985.

38. The defendant (managing director) was accused of carrying on business involving deals between the merchant bank and his Canadian companies, using inflated fee advances for advisory reports which were never used, repurchase agreements were held to be "bogus" since there were no securities to which they related, and non existent certificates of deposit were reportedly sold between the companies. Rose LJ had this to say:

> *"In our judgment the word creditor in s 458, in its ordinary meaning, denotes one to whom money is owed: whether that debt can presently be sued for is immaterial. This is sufficient to decide the present case. But we see no reason in principle why other kinds of creditors should not be within the scope of s 458 because such may come into existence after the fraudulent trading has first begun . Such a construction is consonant within the purpose of the first part of the section which is aimed at preventing insolvent trading to the prejudice of those who are induced to do business."*[26]

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25 (1996) 2 BCLC 109

26 ibid, p 122

The Draft Companies Bill[27]

39. The preceding paragraphs are based on the present legislation. The draft Companies Bill introduces a new provision in addition to the current provision on directors' liability for fraudulent trading. The new provision provides that a current or past director of a company may be liable to pay such contribution to the company's assets for wrongful trading, if, on a winding up of the company, it appears that:

    i. the company has gone into insolvent liquidation;

    ii. at some time before the commencement of the winding up of the company that person knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and

    iii. that person was a director of the company at that time. If the Court is satisfied that the director took every step with a view to minimizing the potential loss to the company's creditors, he will not be liable.

In deciding whether a director ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation both an objective tests (knowledge, skill and experience of the reasonable director) and a subjective test (the general knowledge skill and experience of the particular director) are applied.

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27 I wish to acknowledge Suzanne Ffolkes-Goldson's assistance in relation to the comments which follow..

40. The provision also applies to "shadow directors." A shadow director is a phenomenon introduced by the draft Companies Bill and includes anyone who in effect controls the directors of the board of the company in that the Board is instructed by this person and follows those instructions.

41. Note that some of the new provisions on disqualification of directors may apply to a director who is found liable for wrongful trading as well as fraudulent trading. Bear in mind also that the proposed increase in the duty of care, skill and diligence may well cover "wrongful trading." The proposed higher standard of duty involves both subjective and objective elements.

C. Third Party Marevas

42. In recent cases, the Courts in both England and Australia have considered situations where the assets of a company have been "mixed up" with the assets of a director. Not only have the Courts recognised the possibility in those circumstances of looking behind the legal ownership of the assets with a view to determining the beneficial owner, but they have gone further and granted Mareva injunctions against an entity which was not the debtor, and at a time when the creditor had no cause of action against that entity.

43. Two interesting cases are considered below. In the first, the bank had a cause of

action against a person and obtained an ex-parte Mareva injunction against a company controlled by him, and in the second, there was a cause of action against the company only , and the plaintiff was able to obtain a Mareva injunction against its directors. In both, the Court was prepared to keep the Mareva injunction in place until it could be ascertained which of the assets legally owned by the third party, should be treated as belonging wholly or in part to the debtor.

44. In **TSB Private Bank International SA** v. **Chabra and another**,[28] the plaintiff bank obtained a Mareva Injunction against a debtor and against a company in which he had an interest. The plaintiff admitted that it did not have a cause of action against the company. Mummery J. said:

> *"I am of the view that there is a good arguable case that there are assets, apparently vested in the company, which may be beneficially the property of Mr Chabra and therefore available to satisfy the plaintiff's claims against him if established at trial. I am also of the view that it is arguable that the company was, in fact, at relevant times the alter ego of Mr Chabra, and that its assets, or at least some of its assets, may be available to meet the plaintiff's claims against him if established."*[29]

45. The Learned Trial Judge continued:

> *"If no injunction is made against the company, there is a real risk that it will*

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28 [1992] 2 All ER, 245

29 ibid, p 252

dispose of assets so as to defeat the plaintiff's chances of satisfying the judgment that it may obtain. The effect of the company disposing of its assets would also be indirectly to reduce the value of any shareholding which Mr. Chabra had, and may still have, in the company. The disposal would have the direct effect of diminishing the prospects of any assets vested in the company which may be Mr. Chabra's beneficial assets, being available in the United Kingdom to meet the plaintiff's judgment."[30]

46. Mummery J. concluded:

"In brief, the most realistic and practical form of relief in this case is to restrain the company from disposing of, or dealing with, assets until it is established whether the plaintiff is entitled to a judgment against Mr Chabra and until it is established which, if any, of the assets apparently vested in the company are available to satisfy any judgment obtained against Mr Chabra."[31]

47. Even more recently, a Court in Australia made a similar ruling in **<u>Led Builders Pty Ltd.</u> v. <u>Eagle Homes Pty Ltd.</u>**[32] After reviewing authorities from England, Australia and New Zealand, the Federal Court of Australia (an appellate Court) granted a Mareva injunction against directors of the "debtor" and against another company which they controlled. Beaumont J (with whom Branson J concurred) said at page

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30 ibid, p 254

31 ibid, p 256

32 (1997) 148 ALR 247

257):

> *"We cannot accept, as the primary judge appears to suggest, that it is an ingredient of the Mareva jurisdiction that the debtor has a specific proprietary interest in the third party's assets...It is sufficient, for present purposes, that the assets of the defendant and the third parties are "mixed up" and "controlled".*

48. The Court held that it would exercise its discretion and grant Mareva relief against directors or other third parties when:

   a) The affairs of the defendant and of the third party are intermingled;

   b) The defendant and its assets are effectively controlled, *de jure* or *de facto,* by the third party;

   c) The defendant's assets will be insufficient to meet the plaintiff's claim;

   d) The plaintiff, although having no vested or accrued cause of action against the third party, may become entitled to have recourse to the third party or its assets to meet the plaintiff's claim; and

   e) There is a danger that the third party will send its assets abroad or otherwise dispose of them.

D. <u>Unjust Enrichment/Restitution</u>

49. It will be noted that in the cases just mentioned, the Courts envisaged that the plaintiff may be able to "have recourse" (in Beaumont J's words) to the assets of the

directors or third parties. They do not indicate, however, how that would be achieved.

50. The traditional and recognized method would be taking control of the company by appointing a receiver or by way of liquidation proceedings, and bringing an action against the third parties in the company's name. I have found no direct authority on the point, but both based on the approach in recent cases and on principle, a creditor should, in my view, be able to bring a claim against directors or other third parties in such circumstances.

51. In an excellent paper titled "Beyond the Watershed: Restitution in the 90s,"[33] C. Dennis Morrison, Q.C. reviewed the more recent authorities on restitution based on unjust enrichment. As those cases indicate, in order to succeed in such a claim, a plaintiff must show that:

a. The defendant has received a benefit;
b. The benefit has been received at the plaintiff's expense; and
c. It would be unjust for the defendant to retain that benefit.[34]

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33 Delivered at the Norman Manley Law School on June 17, 2000

34 See Goff & Jones, The Law of Restitution, Fourth edition, p 16

52. In most cases, it will probably be relatively easy to establish a. and c. above, and the difficulty will be in satisfying the Court that the benefit obtained by the directors or other third parties has been at the expense of the plaintiff/creditor. In my view, the creditor should be able to establish this by showing that:

a. The company is insolvent and the creditor is unable to recover the debt; and

b. If the funds or assets improperly received by the third party still formed part of the company's assets, they would have been available to the creditor.

53. It may be argued that if the Courts took this approach, they would be giving one unsecured creditor a preference over other creditors, because the detriment suffered by that creditor was equally suffered by them all. The fact is, however, that until winding up proceedings are instituted, unsecured creditors do not share equally in the assets of the debtor, they do so on a "first come first served" basis. If the asset was still in the company's possession, this creditor would have been able to execute judgment against it. Alternatively, if the third party admitted that it owed a debt to the company, this creditor would be able to obtain, in the same proceedings, a garnishee order attaching that debt, and directing its payment directly to this creditor. If the Court is of the view that the sum is payable by the third party to the company therefore, I can see no reason why should it not order in the same proceedings, that it be paid directly to the creditor.

54. The following are two factual situations which are not uncommon, and which may

be appropriate for the application of this approach:

a. A company's debts exceed its assets. The directors cause a new company to be incorporated, and transfer some of the assets from the debtor company to the new company without the payment of adequate consideration. In my view, the creditor can sue both companies and claim:

   i. A Mareva Injunction against both (assuming that the various requirements of a Mareva Injunction are satisfied);

   ii. The debt owed by the debtor company;

   iii. An order that the new company pay to the creditor on the basis of restitution, the value of the assets received (less any sums paid for them).

   Needless to say, the creditor cannot recover more than the total due to it.

b. A company's debts exceed its assets and the directors have not guaranteed the debts. The directors treat the company's assets as their own. They use property owned by the company without paying rent, transfer the company's funds to themselves without proper justification, or purchase the company's assets for less than market value. In my view, these directors can be joined in any action against the company and relief sought against them as in a. above.

55. As I indicated earlier, I have found no direct authority on this point. The learned authors of **The Law of Restitution** refer to a number of circumstances in which the benefit received by the defendant came not from the plaintiff but from the third party, but where the plaintiff was nonetheless granted restitution against the defendant.[35] They refer to rent cases as perhaps, the oldest example of this kind of case. A third party intervenes without the landlord's consent and collects rent due from a tenant. The Landlord has been able to successfully claim against that third party.[36] Many other examples are given, none of which include the situation we now contemplate. At the end of their review of the decided cases, however, the learned authors observe:

> *"In the light of these decisions, this category of cases should not be regarded as closed."*[37]

56. There are at least two cases now pending in the Jamaican Courts, however, where similar claims are being made, and where the sums involved make appeals likely. This issue is therefore certain to be addressed by our Courts in the near future.

B. ST. MICHAEL HYLTON

July 8, 2000

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35 ibid, p 36

36 ibid, p 579

37 ibid, p 580