

## COMMENTS

### WRONGFUL TRADING: COMPARATIVE APPROACH (ENGLAND AND WALES, RUSSIA AND THE USA)

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*This paper is designed to discover legal rules addressing insolvency trading in three jurisdictions: England and Wales, Russia and the USA. Originally it was a master's dissertation written under supervision of Ms. Sarah Paterson, who was extremely helpful and patient. The key jurisdiction for the research is England and Wales, whose wrongful trading provision apparently was the very first insolvency regulation in the field. Here, we will give particular attention to the factual circumstances of insolvency trading and research how the concept of wrongful trading addresses them. The next question will be how the American concept of deepening insolvency and the Russian concept of subsidiary liability are comparable with wrongful trading. Later, we will focus on the functions that should be performed by the regulations. Also, the effectiveness of wrongful trading and similar overseas provisions will be examined. Finally, this paper attempts to find obstacles to the wide application of wrongful trading provision.*

*Keywords: wrongful trading; deepening insolvency; subsidiary liability; liability of directors.*

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#### 1. Introduction

When an insolvent company continues trading, it tends to be harmful for creditors, other businesses and public in general. Insolvent trading was recognized as a problem many years ago, but there is still no effective legal mechanism to deal

therewith. In 1926, the Greene Committee offered a new concept which would make directors liable if they fraudulently carried on business of an insolvent company;<sup>1</sup> but this concept, which was called 'fraudulent trading,' never became an effective tool of insolvency law mainly due to the fact that it combined a criminal offence and a civil cause of action.<sup>2</sup> The development of the concept was introduced by Sir K. Cork,<sup>3</sup> who offered to remove the criminal burden of proof and allow the court to make a monetary order against directors on petition of creditors or the liquidator. Also Sir K. Cork offered to name the new concept 'wrongful trading.' The idea of wrongful trading has been accepted by sec. 214 of the Insolvency Act 1986; under this section the court can oblige directors to pay a contribution to the company if they knew that the company was near insolvency and did not make the reasonable steps to protect creditors. But, in contrast to Cork's idea, the petition can be made only by the liquidator. The wrongful trading provision was met enthusiastically by scholars,<sup>4</sup> but for some years the concept was obviously labelled as a 'paper tiger.'<sup>5</sup>

This paper is designed to discover why wrongful trading is not widely used in the UK. To do that we will try to compare the wrongful trading law and approaches to liability of directors for the insolvent trading used in two other jurisdictions: the USA and Russia. These jurisdictions have been chosen because their approaches are different from each other, but both have something common with the English one. The USA is another common law jurisdiction, and undoubtedly it is much closer to English law overall. But American bankruptcy legislation does not have a concept which would be similar to wrongful trading; directors might be liable there for insolvency trading under a tortious concept instead. At the same time, Russia is a continental civil law country, but there is a cause of action which, as we will see, functionally is very close to wrongful trading.

The mentioned jurisdictions will be analyzed in the first chapter. We will start with the English concept of wrongful trading and focus on four hypothetical scenarios of insolvency trading. It is important here to find out which particular parties are harmed by wrongful trading more than others; it is obvious that they should be protected more, and it is crucial to allow them to use wrongful trading provision directly as they would apply it more than anyone else. We argue that the creditors trading with the insolvent company through its tough time always suffer from insolvency trading; however, they are not protected by wrongful trading provision.

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<sup>1</sup> Kenneth Cork, *Insolvency Law and Practice: Report of Review Committee 29* (Her Majesty's Stationery Office 1982).

<sup>2</sup> *Id.* at 388.

<sup>3</sup> *Id.* at 390.

<sup>4</sup> Andrew Hicks, *Advising on Wrongful Trading: Part 1*, 14 *Company Lawyer* 16 (1993).

<sup>5</sup> Carol Cook, *Wrongful Trading: Is It a Real Threat to Directors or a Paper Tiger?*, 1999 *Insolvency Lawyer* 99.

At the same time, the creditors as whole, who are protected by the provision, might even benefit from insolvency trading.

Then the discussion will move on to the American 'deepening insolvency' which originally was a part of tort law; the main question here is whether this concept addresses the same situations as wrongful trading does. American experience is crucial for us because it is another common law jurisdiction and legal solutions found there might be workable in the UK. Particular attention will be paid to the negligent behaviour of directors in deepening insolvency. Finally, we will look at the subsidiary liability concept which is used in Russia and compare it with the English concept. The similarities and differences between these two jurisdictions are important as both countries use similar concepts which are stated in the legislation and expected to perform the same function. As both concepts are not really effective, it is possible to check which particular rules are shared by them and might cause the difficulties in making directors liable for the insolvent trading.

The second chapter develops the idea about a proper function of wrongful trading. Here, we will investigate how wrongful trading performs compensatory or punitive functions. In our view finding the particular function, which wrongful trading should perform, should be done before discussing effectiveness of the concept. Once we have found what the wrongful trading should achieve, it is possible to decide whether it does achieve this goal or not. This question seems to be quite obvious, but in reality it is complicated. It seems that the American deepening insolvency and the Russian subsidiary liability are compensatory, not punitive; but the English wrongful trading is neither really compensatory nor punitive.

This discussion will be developed in the fourth chapter, which is about effectiveness of wrongful trading provision as well as the similar provisions in the USA and Russia. In the first part of the chapter some figures will be shown; special attention will be paid to the number of wrongful trading cases and other insolvency misconduct cases.

Finally, the possible ways to improve the current situation will be discussed in the fifth chapter. The specific question here is how American and Russian insolvency laws could contribute to the English concept of wrongful trading.

## **2. Wrongful Trading and Alternatives**

In this chapter we will cover mechanisms which might be used against directors whose misconduct before the insolvency caused damages to the company and creditors. While analyzing the English concept of wrongful trading, we will look at four possible situations when insolvent trading appears; the criterion used is how the company's assets are affected by such trading. In the next part we will describe the American concept of deepening insolvency as a part of the American tort law and as an independent cause of action; then it will be compared with the wrongful trading

concept, especially in the cases when deepening insolvency includes negligent behaviour of directors. Finally, the Russian concept of subsidiary responsibility will be analyzed through similarities and differences with wrongful trading; specific attention will be given to performance of compensatory and punitive functions and possible plaintiffs for such claims.

### **2.1. England and Wales**

Creditors in this jurisdiction are protected by a wide range of mechanisms, but only wrongful trading protects them exactly against continuing trading of the insolvent company. The creditors trading with an insolvent company are the only parties who always suffers damages; however, they do not have the right to sue directors directly.

In the UK creditors are protected by common law duties of directors raised before the insolvency, directors' disqualification provisions, concepts of fraudulent and wrongful trading;<sup>6</sup> but only the latter specifically addresses continuing trading of the insolvent companies. Under sec. 214 of the Insolvency Act 1986 the court on the application of the liquidator may declare that that a director of the company in liquidation is to be liable to make such contribution to the company's assets as the court thinks proper if at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. The director avoids responsibility if he / she took every step to minimize the losses of the creditors.

The only plaintiff for a wrongful trading claim is the liquidator and only remedy is a contribution to the company's common pool; therefore, the wrongful trading provision protects only the company's creditors as whole. A. Keay argues that only unsecured creditors are protected by the provision.<sup>7</sup>

But in our view, it is not clear who should be protected by this regulation. Initially, Sir K. Cork mentioned the wide range of parties who could be concerned about wrongful trading and expected to have the right to sue directors on this ground.<sup>8</sup> Even though the legislature did not follow K. Cork on this matter, there are many parties which might be affected by the wrongful trading. The first are the businesses who were trading with the company through the tough times. They enter into transactions which were necessarily harmful for them as the insolvent company was not able to pay; these losses have been caused by directors of the insolvent

<sup>6</sup> Prof. D. Kershaw underlines that directors' common law duties appeared prior insolvency and wrongful trading provisions are only mechanisms require directors to have regards to creditors' interest (David Kershaw, *Company Law in Context: Text and Materials* 788 (2<sup>nd</sup> ed., Oxford University Press 2012)).

<sup>7</sup> Andrew Keay, *Wrongful Trading: Problems and Proposals*, 65 N. Ir. Legal Q. 63 (2014), available at <<http://eprints.whiterose.ac.uk/78501/>> (accessed Aug. 11, 2015) [hereinafter Keay, *Wrongful Trading*].

<sup>8</sup> Cork, *supra* n. 1, at. 399.

company who continued trading after being informed about company's insolvency. At the same time, company's creditors as whole do not always suffer losses from wrongful trading itself.

What is more, the original idea was protecting new creditors of the insolvent company. Sir K. Cork, when discussing reasons to implement wrongful and fraudulent trading, cited the Greene Committee, who developed the idea of fraudulent trading.<sup>9</sup> The Greene's idea addressed a situation when the floating charge holder controlling the company obtained the credit to buy goods and 'fill up' the company assets. Thereby new creditors of the company were harmed and needed the protection, which finally was given by the fraudulent trading provision. The Cork's recommendation was that wrongful trading had to address the same situation as fraudulent trading, but would not need the proof of dishonesty and would not require the criminal standard of proof.<sup>10</sup> Thus, initially both concepts were aimed to protect new creditors, not those who were creditors before the insolvency.

To demonstrate how wrongful trading might harm creditors of both types we will look at four possible scenarios.<sup>11</sup> In the first situation a company buys some goods for price £100, the seller becomes a company's creditor for £100, but company owns the goods which market price is £100. Assuming that the liquidator is able to realize these goods for their real price, the common pool of the company has not changed. So, finally no prior creditors are affected by trading. But the seller has exchanged his goods for the status of a creditor of the insolvent company instead of getting £100 which he considered. Ironically, in this situation creditors as whole benefit from the insolvent trading. The counterparty of the insolvent company becomes a creditor with the demand of £100, but it will get return only *pro rata*. The common pool available for distribution to all creditors increases by £100 received. And the less a company pays to the counterparty outside the insolvency proceeding, more other creditors benefit.

In the second situation, which is quite obvious, the company is not able to pay all debts and pays, for example, only 80% of the debts instead. Again, the common pool wins. The assets available for distribution to all creditors increase by £20 (£100 received minus £80 paid). The real cases, when the wrongful trading provision was applied, prove this position. For example, in *Roberts v. Frohlich & Anor*.<sup>12</sup> directors were found liable for trading wrongfully when they were using credit extended by suppliers to trade. It is quite clear that the described action cannot be harmful for the previous creditors of the company, but causes losses for suppliers. In *Re*

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<sup>9</sup> Cork, *supra* n. 1, at 29.

<sup>10</sup> *Id.* at 399.

<sup>11</sup> It is assumed that goods received by the company will be realized through liquidation for their market price. If it is not, it cannot be a concern for wrongful trading at all. Efficiency of insolvency liquidation definitely is not a subject of wrongful trading; directors should not pay for the wasteful liquidation.

<sup>12</sup> [2011] EWHC 257 (Ch.).

*Kudos Business Solutions Ltd.*<sup>13</sup> directors paid away sums received from customers as advanced payments what constituted wrongful trading. The payments were harmful only for these particular creditors listed by the court, but not for creditors of the company as whole. However, creditors, who suffered losses, in the described situation are not recognized by law as parties who need protection. The only way they benefit from wrongful trading provision is from a part of directors' contribution to the common pool which they will get *pro rata* and along with other creditors, who have already benefited from wrongful trading.

The third situation covers cases where the company pays for the goods more than their market price; the result is a loss for the company and the common pool. If the company has bought some goods for £100 which cost £80 on the market, all creditors will get return from the common pool which is £20 less. The most obvious reason why the company comes to such transactions is fraud; but fraudulent trading is a competing cause of action, both fraudulent and wrongful trading hardly can be applied together. Also such transaction might be undervalued or preferable; it is possible to base claims on the wrongful trading and such transactions at the same time. But in this case remedy is limited to the price of the transaction; wrongful trading as a part of the claim creates additional burden of proof, but the same compensation might be received by the claim based only on an undervalued or preferable transaction. The only advantage is that the wrongful trading claim allows adding the director as a defendant. The alternative version of this situation is when the company pays its debts to some particular creditors while other creditors cannot get anything.<sup>14</sup>

The fourth situation covers cases when the company and creditors suffer losses from the continuing trading itself. For example, a company with assets equal to £10,000 was trading for three months after its insolvency became foreseeable. Even though the business was obvious, after these three months company's assets cost only £9,000 due to a purely economic problem with the company's profitability. These losses were caused by trading itself, not directors' misfeasance. Everybody is harmed, but in practice the wrongful trading provision is not applied in this scenario. There are no cases where the court found wrongful trading without any other wrongdoings and there are very few cases where the court articulated continuing business as a misfeasance which made wrongful trading.<sup>15</sup> What is more, A. Keay very recently noted that courts applying wrongful trading in fact 'consider issues of blameworthiness in determining liability.'<sup>16</sup> This idea is not based on law, but articulates the logic which is factually used by the courts. In other words, the courts

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<sup>13</sup> [2011] EWHC 1436 (Ch.); [2012] 2 B.C.L.C. 65.

<sup>14</sup> *Re DKG Contractors Ltd.*, [1990] B.C.C. 903.

<sup>15</sup> *See, e.g., Re Continental Assurance Co. of London plc*, [2007] 2 B.C.L.C. 287; [2001] All. E.R. (D) 229.

<sup>16</sup> Keay, *Wrongful Trading*, *supra* n. 7, at 70.

are very reluctant to challenge behaviour of directors who did not file insolvency petition only, and had not done anything wrong apart it.

The other party which could be concerned about wrongful trading is the public. First, wrongful trading is misconduct which always damages the social well-being. Secondly, it damages the economy as whole, especially in the cases when the insolvent company has many creditors such as local entrepreneurs for whom the insolvent business might be only contra-party. But the current regulation of wrongful trading does not address interest of the public; the liquidator does not have any real duty to protect public interests. In view of that, the public interests are protected by wrongful trading only indirectly by discouraging directors from such misbehaviour.

Hence, so far wrongful trading gives protection only to creditors of the company as whole; however, the specific creditors, who were counterparties of the company through insolvency, are likely to suffer losses much more than creditors who became them before. It is noticeable that this idea was initially implied into both wrongful and fraudulent trading, but later was changed by legislature and courts to the form which exists now.

## **2.2. The USA**

In the USA there is no federal legislation which would prohibit continuing trading of the insolvent companies; the closest to the wrongful trading functionally is a common law concept of deepening insolvency, which initially was based on tort law. However, this concept addresses more the situation of fraudulent than wrongful trading; only in the very rare cases, when the courts assume that deepening insolvency includes negligent behaviour, does it perform a function similar to wrongful trading.

P. Rubin defined deepening insolvency as 'an injury to the corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.'<sup>17</sup> This concept is functionally comparable with the UK wrongful trading,<sup>18</sup> even though in the USA there are other instruments which make directors liable for the misconduct beyond insolvency, such as common law duties regulated by the business judgement rule, duties on sale and duties on Tit. 11 of the US Code. Deepening insolvency is based on any misconduct prior to insolvency and hence has wider application than wrongful trading. This concept is a development of tort law and originally covered only fraudulent behaviour of directors which made it more similar to fraudulent trading. However, nowadays courts apply deepening insolvency against negligent directors;<sup>19</sup> so, it covers the wrongful trading situation as well.

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<sup>17</sup> Paul Rubin, *New Liability under 'Deepening Insolvency': The Search for Deep Pocket*, 23 Am. Bankr. Inst. J. 50 (2004), available at <<http://www.herrick.com/siteFiles/Publications/805D53435768CE5436A02FF829D497C8.pdf>> (accessed Aug. 11, 2015).

<sup>18</sup> See, e.g., Michael Schillig, *'Deepening Insolvency' – Liability for Wrongful Trading in the United States?*, 30 Company Lawyer 298 (2009).

<sup>19</sup> *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1005 (9th Cir. 2005); *Gourian Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (In re Gourian Holdings, Inc.)*, 165 B.R. 104, 107 (E.D.N.Y. 1994).

Deepening insolvency has two applications in the USA.<sup>20</sup> First, it might be a measure for the separate tort action. Initially deepening insolvency was a corollary to an independent tort and was designed to measure the damages caused to the company by continuing trading;<sup>21</sup> it keeps playing this role. Secondly, it might be a separate cause of action, but in this case activities of defendants should be fraudulent<sup>22</sup> or, arguably, negligent (*Smith v. Arthur Andersen LLP*; *Gourian Holdings, Inc. v. DeSantis*). As we said above, only in the latter case deepening insolvency addresses the same situation as wrongful trading does. But the liability for negligent deepening insolvency seems to contradict<sup>23</sup> the business judgement rule<sup>24</sup> which protects directors against legal liability for their business activities. We assume that business judgement rule is not applied in such cases simply because a cause of actions gives specific regulation which should be applied instead of a general rule; but the uncertainty is still here.<sup>25</sup> In 2006 William A. Brandt and Catherine E. Vance in their comparative analysis mentioned that it was difficult to say whether deepening insolvency and wrongful trading were 'headed toward or away from each other in their development.'<sup>26</sup> Nowadays in the USA there is a clear distinction between fraudulent and negligent deepening insolvency, and it is possible to make a conclusion. Deepening insolvency may serve the same function as wrongful trading, but only if we do not follow the mainstream logic that it should contain fraud (*Lafferty*), and do not apply the business judgement rule. But even in this case, to make directors liable the plaintiff should prove that their behaviour was negligent to the extent that it constitutes a breach of their fiduciary duties owed to the company or creditors (*Smith v. Arthur*), which requires a burden of proof harder than for wrongful trading.

The tortious origin makes deepening insolvency different from wrongful trading. It is possible to use the American concept only when there is damage for to company.<sup>27</sup> This damage is not simply a sum of trading, it should be an actual

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<sup>20</sup> John Tully, *Plumbing the Depth of Corporate Litigation: Reforming the Deeping Insolvency Theory*, 2013 U. Ill. L. Rev. 2087, available at <<http://www.illinoislawreview.org/wp-content/ilr-content/articles/2013/5/Tully.pdf>> (accessed Aug. 11, 2015).

<sup>21</sup> Sara E. Apel, *In Too Deep: Why the Federal Courts Should Not Recognize Deepening Insolvency as a Cause of Action*, 24 Emory Bankr. Dev. J. 85, 86 (2008).

<sup>22</sup> *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001); *Dixon v. Am. Cmty. Bank & Trust (In re Gluth Bros. Constr., Inc.)*, 424 B.R. 379, 390 (Bankr. N.D. Ill. 2009).

<sup>23</sup> J. Tully argues that when deepening insolvency is applying for the negligent behaviour, it contradicts with the business judgement rule which is a presumption that business decisions of directors cannot be challenged if they are made in good faith, on well informed basis, without conflict of interests and with the care of the ordinary prudent person (Tully, *supra* n. 20, at 2108).

<sup>24</sup> *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

<sup>25</sup> *In re P.S.E. & G. Shareholder Litigation*, 315 N.J. Super. 323, 327 (Ch. Div.1998).

<sup>26</sup> William A. Brandt, Jr., & Catherine E. Vance, *Deepening Insolvency and the United Kingdom's Wrongful Trading Statute: A Comparative Discussion*, 19 *Insolvency Intelligence* 156, 158 (2006).

<sup>27</sup> *See, e.g., Schacht v. Brown*, 711 F.2d 1343, 1357 (7th Cir. 1983).

loss experienced by the company or creditors. So, for example, in the hypothetical situation described above, while discussing the wrongful trading, directors probably would not be liable under deepening insolvency; or, at least, it would be very difficult for creditors to prove that the new company's debts are their actual damage.

The other consequence of the nature of deepening insolvency is that this concept does not limit possible plaintiffs and defendants. For example, creditors are able to sue directors or third parties, such as auditors, on the grounds of deepening insolvency. In our view, it is an advantage of the concept. Eventually, creditors are the only parties who are really interested in such suits; when they have the right to sue directors, they do it much more actively and successfully than the liquidator. This idea is also supported by the fact that the vast majority of American cases discussed in this chapter are started by creditors.

Therefore, technically both wrongful trading and deepening insolvency address the same situation, but with the very different approach. The biggest difference is that the English concept is made by the legislature while the American one is made by common law<sup>28</sup> and continues developing. On the other hand, deepening insolvency, unlike wrongful trading, is based on tort law which is a traditional part of the common law. American courts applying this concept do not face with any new or unusual obstacles such as English courts do when they try to apply the artificial wrongful trading. But both English and American courts struggle with measurement of damages caused by insolvency trading.<sup>29</sup>

It is also important to remember that in these countries there are different policies regarding liability of directors. In the USA the default rule is that directors cannot be liable for the business decisions unless they have violated the very specific business judgement rule; what is more, the whole American corporate law might be described as manager-oriented.<sup>30</sup> To the contrary, in England directors duties are stated in the Companies Act 2006 and their breach is followed by their liability. Overall, American corporate law is considered to give directors much more freedom in their business activities. Probably, a rule working as the wrongful trading provision would look very antagonistic there.

In conclusion, deepening insolvency is still developing and sometimes functionally works as wrongful trading. The American experience proves that

<sup>28</sup> Look Chan Ho, *On Deepening Insolvency and Wrongful Trading*, 20 *Journal of International Banking Law & Regulation* 426 (2005), available at <[http://papers.ssrn.com/abstract\\_id=741024](http://papers.ssrn.com/abstract_id=741024)> (accessed Aug. 11, 2015).

<sup>29</sup> Schillig, *supra* n. 18, at 300.

<sup>30</sup> Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law* (Yale Law School, Program for Studies in Law, Economics, and Public Policy, Law and Economics Working Paper No. 235; New York University, Center for Law and Business, Law and Economics Working Paper No. 013; Harvard Law School, John M. Olin Center for Law, Economics, and Business Discussion Paper No. 280; Yale School of Management, International Center for Finance Working Paper No. 00-09, January 2000), <[http://papers.ssrn.com/abstract\\_id=204528](http://papers.ssrn.com/abstract_id=204528)> (accessed Aug. 11, 2015).

creditors tend to submit more claims based on the insolvency trading. At the same time, it is possible to have a working concept which requires even a harder burden of prove that wrongful trading does.

### **2.3. Russia**

Subsidiary liability is an instrument of the continental law which makes directors liable for company's debts acquired through insolvency on petition of the liquidator or a creditor; functionally this concept is quite similar to wrongful trading.

Russia is a continental law country and uses a different approach to the regulation of directors' behaviour. Unlike common law jurisdictions, in Russia the legislation contains rules which regulate almost every aspect of corporate life and do not allow directors too much space for decision making. Directors owe fiduciary duties to the company, but a breach of the rules cannot be an independent cause of action; a broad concept of damages should be applied instead. At the same time, law sets out a number of specific causes of actions which are to be used in the specific situations.

One of such causes of actions is subsidiary liability<sup>31</sup> of directors listed in Art. 10(2) of the Federal Law No. 127-FZ of October 26, 2002, 'On Insolvency (Bankruptcy)' [hereinafter Federal Law on insolvency]. Under Federal Law on insolvency, directors, who did not file the insolvency petition when obligated, are liable as subsidiaries for the new company debts on the petition of the liquidator or a creditor. The duty to file an insolvency petition arises when the company is not able to pay its debts or does not have enough assets to pay the debts or if the payment to one creditor could make impossible payments to other creditors (Art. 9 of the Federal Law on insolvency). However, nonfulfillment of insolvency petition is not the only ground for subsidiary responsibility; the same legal consequences follow the intentional insolvency and in the case where the insolvent company has not transferred documentation to the liquidator.

Surprisingly, subsidiary responsibility is quite close to wrongful trading; these concepts even share some problems and features. The main reason is that wrongful trading and subsidiary responsibility were established artificially as the specific mechanisms of insolvency law while deepening insolvency is a development of tort law.

First, under both concepts if directors continue trading when the company is approaching insolvency, they might be liable for paying a contribution to the company's common pool.

Secondly, in both jurisdictions directors pay contribution to the company's common pool and these contributions finally are to be distributed to all creditors. In contrast, in the USA damages are paid to the plaintiff who might be a creditor.

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<sup>31</sup> The very similar concept of German law called '*Insolvenzverschleppungshaftung*'. See, e.g., Thomas Bechner, *Wrongful Trading – A New European Model for Creditor Protection?*, 5 *European Business Organization Law Review* (EBOR) 293 (2004).

Thirdly, under both Russian and English concepts contribution from directors is directly connected to the size of company's debts while in the USA the remedy is to compensate for the actual damage which to creditors or the company suffered. Fourthly, the administrative procedure in Russia is also more frequently used<sup>32</sup> than subsidiary responsibility.

It is also noticeable that Russian courts have made subsidiary responsibility even more similar to deepening insolvency. In both Russia and England the fruits of the claims cannot be assigned; in both countries the courts emphasize that such claims belong the creditors, not the liquidator, even though he / she is the only possible plaintiff.<sup>33</sup> Russian courts also apply the concept only in the insolvent liquidation and make liable not only *de jure* directors, but *de facto* and shadow directors as well.<sup>34</sup> Russian courts also tend to check whether directors actually knew about approaching insolvency.<sup>35</sup>

However, there are some differences. The main one is that unlike wrongful trading, liability of directors in Russia is possible only if, in the insolvency proceedings, it appears that the company's assets are not enough to pay all creditors. But it is quite obvious that in the insolvency liquidation assets are not sufficient to pay all creditors. It might be said that this rule is no more than a way to measure director's contribution to the common pool. Such a measure does not reflect the damage to the company and creditors or how wrong director's behaviour was. But it gives judges a clear formula to determine the director's contribution to the company, which is clearly necessary for continental law judges. Such a rule improves certainty, but decreases flexibility. The other downside is that such remedy might be applied only when the general distribution to creditors has finished.

Also Russian legislation formally does not require proof of knowledge by directors about the poor financial condition of the company. In our view, Russian legislature had two rationales for this rule. First, presumably directors should be aware about company's inability to pay debts; if they do not, they do not perform their duties properly. Secondly, it makes plaintiff's burden of prove much easier. Proving

<sup>32</sup> See, e.g., <<http://www.klerk.ru/inspection/359569/>> (accessed Aug. 11, 2015).

<sup>33</sup> See, e.g.: Ruling of the Federal Commercial Court of the Moscow District of October 29, 2009. Case No. A40-22082/08-123-70, at <[http://kad.arbitr.ru/PdfDocument/9699218e-a764-45f5-87ff-d559d4497a2a/A40-22082-2008\\_20091029\\_Reshenija%20i%20postanovlenija.pdf](http://kad.arbitr.ru/PdfDocument/9699218e-a764-45f5-87ff-d559d4497a2a/A40-22082-2008_20091029_Reshenija%20i%20postanovlenija.pdf)>; *Re Oasis Merchandising Services Ltd.*, [1998] Ch. 170; [1997] 2 W.L.R. 765.

<sup>34</sup> Курбатов А. Субсидиарная ответственность руководителей при несостоятельности (банкротстве) возглавляемых ими кредитных организаций // Хозяйство и право. 2007. № 7 [Kurbatov A. *Subsidiarnaya otvetsvennost' rukovoditelei pri nesostoyatel'nosti (bankrotstve) vosglavlyаемых ими kreditnykh organisatsii // Khozyaistvo i pravo*. 2007. No. 7 [Aleksey Kurbatov, *The Subsidiary Liability of the Directors for Insolvency of the Companies*, 2007(7) *Economy and Law*]].

<sup>35</sup> Ruling of the Federal Commercial Court of the Moscow District of March 14, 2014. Case No. A40-24703/2009, at <[http://kad.arbitr.ru/PdfDocument/2f1edd33-0fe6-48a0-be5b-2a3913fb3f4b/A40-24703-2009\\_20140314\\_Reshenija%20i%20postanovlenija.pdf](http://kad.arbitr.ru/PdfDocument/2f1edd33-0fe6-48a0-be5b-2a3913fb3f4b/A40-24703-2009_20140314_Reshenija%20i%20postanovlenija.pdf)> (accessed Aug. 11, 2015).

knowledge of directors about company's insolvency is a significant obstacle even for the common law courts;<sup>36</sup> in the continental courts knowledge can be proved only in the very exceptional circumstances. As the Federal Law on insolvency does not ask for knowledge of directors about this fact, they might be liable if they did not know and even could not know that they had to file insolvency petition. But, as we mentioned above, in the very recent ruling the Federal Commercial Court of the Moscow District stated that an innocent director cannot be subsidiarily liable for the company's debt (case No. A40-24703/2009).

Overall, the Russian concept is very similar to wrongful trading, but creditors in Russia are entitled to file such claims, and there is a formula for calculation of the remedy. In the next chapter it will be shown that Russian subsidiary liability is used more often than wrongful trading and the majority of such claims are filed by creditors. The burden of proof for subsidiary liability and wrongful trading are stated in the Russian and the English laws differently, but the courts tend to ask for the same evidence in both countries.

### 3. Functions of Wrongful Trading

There are two basic functions which could be performed by wrongful trading: compensation and punishment. However, wrongful trading is badly-equipped to perform either of them.

K. Cork mentioned explicitly only the compensatory function of wrongful trading; in his words, the offence should be reserved for fraudulent trading while compensation of losses is the aim of wrongful trading.<sup>37</sup> On the contrary, V. Finch<sup>38</sup> analysed Cork's position that insolvency law should provide the investigative process<sup>39</sup> and concluded that punishment for the misfeasance of directors is a function of wrongful trading. We will follow the same logic.

A contribution to the common pool is deemed by the law as the remedy for wrongful trading; even though it is not necessarily equal to the losses caused by insolvency trading, it is supposed to be a recovery of loss. Hence, originally wrongful trading was expected to be compensatory.

But a punitive or, at least, a deterrent element might be still here. It could even be said that wrongful trading cannot be really compensatory. The directors, who allow

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<sup>36</sup> Andrew Keay, *Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective*, 25 *Legal Stud.* 431, 439 (2005) doi:10.1111/j.1748-121X.2005.tb00678.x [hereinafter Keay, *Wrongful Trading and the Liability*].

<sup>37</sup> Cork, *supra* n. 1, at 399.

<sup>38</sup> Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* 678 (2<sup>nd</sup> ed., Cambridge University Press 2009).

<sup>39</sup> Cork, *supra* n. 1, at 63.

the insolvent company to continue operating, do not get any personal benefits from that; so, compensation, or, more precisely, vindication is not possible here. Historically punitive remedies were used for negligent torts, where it was not possible to restore both injured and injuring parties to the prior economic position.<sup>40</sup> The US Supreme Court in *Cooper v. Leatherman* analyzed the contemporary and historic punitive damages in the USA and said that such damages were initially aimed to compensate losses caused by negligent behavior, which could not be counted as actual losses; but nowadays they are punitive because they exceed actual losses as much as they deter parties from tortious behavior.<sup>41</sup> Under the same logic, remedies for wrongful trading are punitive, but perform compensatory function as they just technically replace the actual losses. At the same time, it would be a simplification to say that directors do not consider prospective liability under wrongful trading provision; at least, the business advisors actively offer them solutions in the field.<sup>42</sup>

But in the USA punitive damages are not applied in deepening insolvency claims;<sup>43</sup> therefore the concept is compensatory. On the other hand, its tortious nature might eventually allow using punitive damages as well.

In Russia there is another view of law's functions. There is a clear distinction between functions which are realized by the state and by the private parties.<sup>44</sup> Punishment cannot be enforced by anyone, but only by the state. As subsidiary liability is brought only by the private parties, this concept must be considered compensatory.

This paper tries to look at the wrongful trading provision from perspective of both possible functions.

### **3.1. Wrongful Trading as a Compensatory Instrument**

Compensation mean

recompense, or satisfaction to the plaintiff, for an injury actually received by him from the defendant . . . the result of the injury alleged and proved, and

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<sup>40</sup> *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424, 121 S. Ct. 1678, 149 L.Ed.2d 674 (2001).

<sup>41</sup> Dan Markel, *How Should Punitive Damages Work?*, 157 U. Pa. L. Rev. 1383, 1392 (2012), available at <<https://www.law.upenn.edu/live/files/90-markel157upalrev13832009pdf>> (accessed Aug. 11, 2015).

<sup>42</sup> Mike Smith, *What is Wrongful Trading and How Can I Avoid Getting Myself into Trouble with Creditors such as HMRC?*, <<http://www.companydebt.com/directors-support/what-is-wrongful-trading>> (accessed Aug. 11, 2015); Jonathan Munnerly, *What Is Insolvent Trading and Wrongful Trading in Business?*, <<http://www.realbusinessrescue.co.uk/business-insolvency/wrongful-trading>> (accessed Aug. 11, 2015).

<sup>43</sup> Schillig, *supra* n. 18, at 300.

<sup>44</sup> *Абрамов А.И. Понятие функций права // Журнал российского права. 2006. № 2 [Abramov A.I. Ponyatie funktsii prava // Zhurnal rossiiskogo prava. 2006. No. 2 [Andrey I. Abramov, The Notion of Law Functions, 2006(2) Journal of Russian Law]].*

that the amount awarded shall be precisely commensurate with the injury suffered, neither more nor less, whether the injury be to the person or estate of the complaining party.<sup>45</sup>

Therefore, to be compensatory wrongful trading should give the full satisfaction to a party suffered loss.

Wrongful trading does not give full compensation to creditors, who were trading with the company through insolvency. The remedy for wrongful trading is a contribution to the company's assets. For the creditors, who were counterparties of the insolvent company, it means that they cannot get compensation in the size of sums traded; instead they are allowed to get a distribution from company's assets *pro rata* as any other creditors. They also do not have a right to sue directors directly; the claim might be brought only by the liquidator on behalf of creditors as whole. However, the liquidator does not owe any direct duties to particular creditors; he / she acts on behalf of all creditors.

Wrongful trading is not necessarily compensatory for company's creditors as whole either; the remedy for wrongful trading is a contribution to the company which court thinks proper. Here we should analyze three possible remedies. The first is based on other instruments applied such as undervalued transactions (sec. 238 of the Insolvency Act 1986) and transactions with preferences (sec. 239 of the Insolvency Act 1986). Unlike wrongful trading, the remedy for them is 'restoring the position to what it would have been if the company had not given that preference' which means these mechanisms are truly compensatory. When wrongful trading and undervalued transactions or transactions with preferences are applied together, the remedy cannot exceed the remedy for undervalued or preferential transactions. In practice it means that the wrongful trading claims are frequently accompanied by the undervalued or preferential transaction claims, but wrongful trading does not have an independent remedy.

Secondly, courts very often order directors to pay sums equal to sums traded.<sup>46</sup> Such a remedy could be compensatory if was paid to creditors with whom the company was trading. But as the contribution is paid to the company, it is not compensatory. The sums traded cannot be losses of the company because the company suffers losses from continuing business as whole, not from the particular transactions. The only exception is the undervalued transactions and the transactions with preferences, which were discussed above.

Thirdly, a remedy might be calculated as the debt which company cannot pay due to insolvency and which appeared through wrongful trading. In *Re Continental*

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<sup>45</sup> *Birdsall v. Coolidge*, 93 U.S. 64, 64 (1876).

<sup>46</sup> *Re Bangla Television Ltd. (in liquidation)*, [2009] EWHC 1632 (Ch.); *Re Transocean Equipment Manufacturing and Trading Ltd.*, [2005] EWHC 2603 (Ch.); *Re Purpoint Ltd.*, [1991] B.C.C. 121; *Re Produce Marketing Consortium Ltd. (in liquidation) (No. 2)*, [1989] 5 B.C.C. 569.

*Assurance Co. of London plc*<sup>47</sup> court ordered directors to pay 'the increase in net deficiency between the relevant dates.' We believe that this approach is the closest to compensation of losses for company's creditors as whole.

But the net deficiency test has two problems. The first problem is that under wrongful trading provisions directors should pay for their concrete actions through the insolvency trading, but not for delay of the insolvency petition's submission. This remedy makes wrongful trading a simplified rule which states that directors should file an insolvency petition when needed, and if they fail to do that, they should compensate the net loss. In fact, it is exactly the continental subsidiary liability concept with the only exception being that in the continental law the contribution to the company is limited to the unpaid debt of the company.

The second problem is how to calculate net deficiency.<sup>48</sup> The simplest method would be based on company's books. But assets might be under-priced in the books and books themselves might be falsified.<sup>49</sup> For example, if the assets were bought for £100 while their market price was £80, company's books still consider them to cost £100. Hence, in this situation net deficiency is useless if based on company's books.

The other option is realizing the assets and using the price received in calculation of net deficiency. But it gives only the price of a company's assets after wrongful trading; the initial price could not be found by this way. The other downside is that if we use this methodology, the wrongful trading claim would be possible only after realization of all assets or, in other words, in some years. For example, in *Official Receiver v. Doshi*<sup>50</sup> the court accepted this test for calculation of remedies and said that it is not possible to make an order until the liquidator has finished all payments to creditors. As we know from the Russian experience, such delay discourages the liquidator from submitting the claim. On the other hand, wrongful trading claim should be filed in the proper time. For example, in *Re Farmizer (Products) Ltd.*<sup>51</sup> the Court of Appeal held that there is the limitation period of six years for the wrongful trading claims; it seems that this limit is easily exceeded if there is a need to sale company's assets. Thus, even the net deficiency test is helpful to measure of losses, it is not the ideal solution.

### **3.2. Wrongful Trading as a Punitive Instrument**

If sums paid to the plaintiffs cannot be compensatory, they have to perform other functions, such as deterrence and punishment. A wrongdoer can be liable only

<sup>47</sup> The same logic in *Re Idessa (UK) Ltd. (in liquidation)*, [2011] EWHC 804 (Ch.).

<sup>48</sup> This problem was a reason to dismiss the wrongful trading claim in *Liquidator of Marini Ltd. v. Dickenson & Ors.*, [2004] B.C.C. 172.

<sup>49</sup> *Re Produce Marketing*, *supra* n. 46.

<sup>50</sup> *Official Receiver & Anor. v. Doshi*, [2001] 2 B.C.L.C. 235.

<sup>51</sup> *Re Farmizer (Products) Ltd.*, [1997] B.C.C. 655.

for damages foreseeable for him,<sup>52</sup> so if directors through wrongful trading do not see damages they cause and, what is more, cannot predict which particular sums they might pay, the remedy is punitive for them. The directors are hardly able to understand economic consequences of wrongful trading for creditors unless such consequences are limited to the sums traded; net deficiency of company simply cannot be even calculated before liquidation. Thus, the remedy for wrongful trading for directors might be considered to be punitive by directors.

But wrongful trading is not really punitive. First, a punitive function cannot be performed without compensation; the punitive damages are a supplement to the compensatory damages (*Birdsall v. Coolidge*) as a defendant should firstly pay or, in other words, compensate, caused loss; only sums which exceed the actual damages might be punitive. As it was discussed above, the courts are reluctant to order payments which exceed the overall sums traded (*Re DKG Contractors Ltd.*).

Secondly, to be punitive a remedy should be calculated as the multiplied harm;<sup>53</sup> the directors would be punished only if they are forced to pay much more than the damage caused, but directors have never been ordered to pay punitive damages for wrongful trading. Directors cannot be punished by paying just the exact sum of the loss and, of course, they cannot be punished by paying a sum which is smaller than the loss. English courts do not order directors to pay sums exceed the sums which were traded wrongfully; thus, at least, in practice wrongful trading is not punitive.

Thirdly, punitive compensation for wrongful trading, even if applied, would be limited by the size of the company's debt. Theoretically, the courts are free to award a punitive contribution. But if they did so, another problem would arise. As directors pay contribution to the company's common pool, such contribution cannot be higher than the overall debt of the company; otherwise, directors would be responsible not only to creditors, but to the company's shareholders as well. It would make wrongful trading to be the same as the continental subsidiary liability.

Fourthly, it is questionable whether the liquidator could be the plaintiff for a claim which has a punitive nature. Under sec. 143(1) of the Insolvency Act 1986 the liquidator should 'secure that the assets of the company are got in, realised and distributed to the company's creditors,' he / she is not directed to do anything extra. But if the liquidator claims for a punitive contribution, he / she is not collecting assets anymore as the sums requested have never been a part of company's assets.

As we can see, wrongful trading is not able to perform either the compensatory nor the punitive function. If this suggestion is right, nobody would be interested in application of the wrongful trading provision. The number of cases based on wrongful trading will be addressed in the next chapter.

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<sup>52</sup> Richard A. Posner, *A Theory of Negligence*, 1 J. Legal Stud. 29, 42 (1972), available at <[http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=3089&context=journal\\_articles](http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=3089&context=journal_articles)> (accessed Aug. 11, 2015).

<sup>53</sup> Benjamin C. Zipursky, *A Theory of Punitive Damages*, 84 Tex. L. Rev. 105 (2005), available at <<http://ssrn.com/abstract=705281>> (accessed Aug. 11, 2015).

## 4. Effectiveness

The wrongful trading provision is rarely applied against directors who misconducted prior insolvency, even there are a lot of such directors. Therefore, this law is almost ineffective.

### 4.1. The Quantitative Analysis

To measure the effectiveness of wrongful trading it is necessary to know two figures. The first is how often directors engage in misconduct after insolvency or, in other words, how they have been deterred by the existing regulations. The second figure has to do with how many directors were found liable for the wrongful trading.

Every year in the UK about 16,000 companies are declared insolvent (e.g., 14,982 in 2013,<sup>54</sup> 16,138 in 2012, 16,871 in 2011). About 1,000 directors are disqualified every year in the UK (e.g., 969 in 2012 and 1,100 in 2011<sup>55</sup>); this mechanism is used against directors more frequently than any others. So, every year approximately 6% of insolvent company's directors are penalized for the misconduct before insolvency; it is not always insolvency trading, but quite often it is.<sup>56</sup>

But very few directors have faced with the wrongful trading claims. Both Westlaw<sup>57</sup> and LexisNexis<sup>58</sup> report one wrongful trading case in 2012 and three such cases in 2011. Thus, in 2012 wrongful trading was applied against 0.006% of insolvent companies' directors and only against 0.1% of disqualified directors; in 2011 against 0.001 and 0.27% of directors respectively. So, there is a significant number of misconduct incidents prior to insolvency, but wrongful trading sanctions are applied rarely. In the other words, directors are not discouraged from misfeasance before insolvency; wrongful trading definitely is not effective.

In the USA deepening insolvency is applied more frequently; there are hundreds of such cases.<sup>59</sup> As it was discussed above, only in the very rare cases does it address the same situations as wrongful trading does. Only liability for negligent actions through deepening insolvency might be compared with wrongful trading, but this

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<sup>54</sup> *Statistics Release: Insolvencies in the Fourth Quarter 2013*, The Insolvency Service (Feb. 7, 2014), <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/287909/pressnotables.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/287909/pressnotables.pdf)> (accessed Aug. 11, 2015).

<sup>55</sup> *Director Disqualification Statistics*, <[https://www.whatdotheyknow.com/request/director\\_disqualification\\_statis\\_2](https://www.whatdotheyknow.com/request/director_disqualification_statis_2)> (accessed Aug. 11, 2015).

<sup>56</sup> *Secretary of State for Trade and Industry v. Walker*, [2003] EWHC 175 (Ch.); *Secretary of State for Trade and Industry v. Blackwood*, [2005] B.C.C. 366; *Official Receiver v. Zwirn*, [2002] B.C.C. 760.

<sup>57</sup> <[www.westlaw.co.uk](http://www.westlaw.co.uk)>

<sup>58</sup> <[www.lexisnexis.com](http://www.lexisnexis.com)>

<sup>59</sup> Kathy B. Phelps, *Deepening Insolvency as a Cause of Action and as a Theory of Damages*, <<http://www.dgdk.com/tasks/sites/dgdk/assets/image/AIRIDeepeningInsolvencyFinal.pdf>> (accessed Aug. 11, 2015).

sort of deepening insolvency is questionable; there are very few cases of this sort. But if we assume that deepening insolvency covers both wrongful and fraudulent trading, it is more effective than two English concepts; at least, overall deepening insolvency is applied more often than wrongful and fraudulent trading in England.

In Russia subsidiary responsibility is not frequently used, but is not dead either. The regional statistics shows that in each Russian region there are about 10 cases annually,<sup>60</sup> which actually means that overall some hundred cases are heard nationally. The Russian courts do not publish the separate figures about subsidiary liability for insolvency trading, but approximately 30% of subsidiary liability cases are based on the insolvent trading. There are about 13,000 insolvency liquidations<sup>61</sup> in Russia every year; so, subsidiary liability claims are filed approximately in 5–10% of insolvency cases. Most of such claims are submitted by creditors,<sup>62</sup> the liquidators try to avoid such claims because of competing remedies which are more effective and quicker than subsidiary liability.

#### **4.2. Obstacles to Applying Wrongful Trading and the Similar Provisions**

A lot has been already written on the problems of wrongful trading,<sup>63</sup> but no researches called this concept effective. Obviously a difficult burden of proof,<sup>64</sup> funding<sup>65</sup> and restriction of possible plaintiffs<sup>66</sup> are blamed as the main obstacles to the wide application of wrongful trading.

The burden of proof is the same for the plaintiffs in Russia and England and is more difficult in the USA. As we see from figures above, the Russian and the American concepts are applied, but English is not. At the same time, in English law the similar

<sup>60</sup> Карлова И.С. Обобщение судебной практики рассмотрения заявлений о привлечении к субсидиарной ответственности в рамках дел о банкротстве за 2011 год и первый квартал 2012 года [Karlova I.S. *Obobshchenie sudebnoy praktiki rassmotreniya zayavlenii o privlechenii k subsidiarnoi otvetstvennosti v ramkakh del o bankrotstve za 2011 god i pervyi kvartal 2012 goda* [Inna S. Karlova, *The Summon Court Practice (2011 – 1<sup>st</sup> quarter of 2012)*]], at <[http://orel.arbitr.ru/process/obobshchenija\\_sudebnoj\\_praktiki](http://orel.arbitr.ru/process/obobshchenija_sudebnoj_praktiki)> (accessed Aug. 11, 2015).

<sup>61</sup> <[http://www.arbitr.ru/\\_upimg/A0397A1AFD76C6B4E3082E213B98BB5D\\_11.pdf](http://www.arbitr.ru/_upimg/A0397A1AFD76C6B4E3082E213B98BB5D_11.pdf)> (accessed Aug. 11, 2015).

<sup>62</sup> See, e.g.: Ruling of the Federal Commercial Court of the Moscow District of April 29, 2010. Case No. A50-20763/09, at <<http://kad.arbitr.ru/Card/751e4441-b406-43bb-a462-2a0685b87091>> (accessed Aug. 11, 2015); Decision of the Moscow City Commercial Court of July 22, 2013. Case No. A40-77172/09, at <[http://kad.arbitr.ru/PdfDocument/62100164-8e66-4f16-9389-2e660041a0de/A40-77172-2009\\_20130722\\_Opreделение.pdf](http://kad.arbitr.ru/PdfDocument/62100164-8e66-4f16-9389-2e660041a0de/A40-77172-2009_20130722_Opreделение.pdf)> (accessed Aug. 11, 2015).

<sup>63</sup> Keay, *Wrongful Trading*, *supra* n. 7; Rainer Werdnik, *Wrongful Trading Provision – Is It Efficient?*, 25 *Insolvency Intelligence* 81 (2012); Richard Schulte, *Wrongful Trading: An Impotent Remedy?*, 4 *Journal of Financial Crime* 38 (1996). doi:10.1108/eb025753

<sup>64</sup> Keay, *Wrongful Trading*, *supra* n. 7, at 71; Werdnik, *supra* n. 63, at 85.

<sup>65</sup> Keay, *Wrongful Trading*, *supra* n. 7, at 72; Werdnik, *supra* n. 63, at 84.

<sup>66</sup> Keay, *Wrongful Trading*, *supra* n. 7, at 75.

burden of proof exists, for example, for the claims based on breach of directors' duties under sec. 174 of the Companies Act 2006. Therefore, it cannot be a major obstacle to application of wrongful trading.

Funding is a problem for English wrongful trading, but is not so crucial for the claims in Russia and the USA. American academics have more concern about overly aggressive plaintiffs<sup>67</sup> who are bringing too many tort claims; so, the problem is the opposite of too little funding as in England. In Russia funding is much easier for the subsidiary claims because of two reasons. First, litigation in Russia is much cheaper in view of continental law traditions, a non-regulated legal profession, etc. Under the quantitative study made by University of Oxford, the price of litigation for the similar case in Russia might be cheaper than in England by 10 times.<sup>68</sup> Secondly, such claims in Russia are brought mainly by creditors who solve their funding problem independently.

Undoubtedly, all these reasons are important for the effectiveness of a wrongful trading remedy; however, some of them seem to be technical. There are some other challenges. For example, in all mentioned jurisdictions it is necessary to know when the company became insolvent in order to hold directors liable under subsidiary responsibility or wrongful trading.<sup>69</sup> In all three countries there are discussions about whether cash flow or balance sheet test should be used.<sup>70</sup> Russian legal researchers are concerned about the shadow directors and their responsibility for actions beyond insolvency,<sup>71</sup> which is a traditional issue for English corporate law scholars. In Russia and England the liquidators cannot assign the fruit of such claims.

But there are, at least, two other problems which are specific for England. The first one is the inability of wrongful trading to perform either a compensatory or punitive

<sup>67</sup> See, e.g.: Todd Zywicki, *Public Choice and Tort Reform* (George Mason University School of Law, Law and Economics Working Paper No. 00-36, October 2000), <[http://papers.ssrn.com/abstract\\_id=244658](http://papers.ssrn.com/abstract_id=244658)> (accessed Aug. 11, 2015); Frank B. Cross, *Tort Law and the American Economy*, 96 Minn. L. Rev. 28 (2011), available at <[http://www.minnesotalawreview.org/wp-content/uploads/2012/01/Cross\\_MLR.pdf](http://www.minnesotalawreview.org/wp-content/uploads/2012/01/Cross_MLR.pdf)> (accessed Aug. 11, 2015).

<sup>68</sup> <<http://www.csls.ox.ac.uk/COSTOFLITIGATIONDOCUMENTSANDREPORTS.php>> (accessed Aug. 11, 2015).

<sup>69</sup> Finch, *supra* n. 38, at 699.

<sup>70</sup> *Rubin v. Gunner*, [2004] EWHC 316 (Ch.); Royston M. Goode, *Wrongful Trading and the Balance Sheet Test of Insolvency*, 1989 J. Bus. L. 436; Мирошников В.А. Банкротство кредитных организаций – проблемы правоприменительной практики [Miroshnikov V.A. *Bankrotstvo kreditnykh organizatsii – problemy pravoprimenitel'noi praktiki*] [Valery A. Miroshnikov, *Insolvency of Banks: Questions of Practice*], *Agenstvo po strakhovaniyu vkladov* (Feb. 18, 2008), <[http://asv.org.ru/agency/appearance/286768/?sphrase\\_id=747589](http://asv.org.ru/agency/appearance/286768/?sphrase_id=747589)> (accessed Aug. 11, 2015).

<sup>71</sup> Спирина Т.А. «Снятие корпоративной вуали» через механизм привлечения к субсидиарной ответственности в рамках дела о банкротстве // Вестник Пермского университета: Серия «Юридические науки». 2014. № 1 [Spirina T.A. 'Snyatie korporativnoi vuali' cherez mekhanizm privlecheniya k subsidiarnoi otvetstvennosti v ramkakh dela o bankrotstve // Vetsnik Permskogo universiteta: Seriya 'Yuridicheskie nauki'. 2014. No. 1 [Tatiana A. Spirina, 'Piercing the Corporate Veil' through Subsidiary Liability in Bankruptcy Case, 2014(1) Bulletin of Perm University: Law]]; Louis G. Doyle, *Anomalies in the Wrongful Trading Provisions*, 13 Company Law 96 (1992).

function; this problem has been discussed in the previous chapter in the details. As the result, the wrongful trading remedy is useless and nobody is encouraged to apply it.

The second problem is the rule stating that the liquidator is the only plaintiff for the wrongful trading claim. This rule creates a situation when the party, who is interested in such claim, does not have a right to file it whilst a party, which can file the claim, is not interested in it.

The liquidator is the only plaintiff for wrongful trading claims, but obviously he / she is discouraged from submitting them. He / she acts on behalf of creditors as whole; but they do not always suffer losses from insolvency trading. The burden of proof for such claim is still difficult; the claim is expensive<sup>72</sup> and there are always problems with funding. The wrongful trading claims are not always successful,<sup>73</sup> but even when they are, it is not predictable which remedy will be applied.<sup>74</sup> At the same time, the liquidator has some other options to challenge company's transactions, for example, as undervalued or preferable; such claims tend to be much more successful, demand a lower burden of proof and have a more certain remedy. Finally, even if the liquidator overcomes all these problems, he / she is not able to assign the fruit of the wrongful trading claim (in *Re Oasis Merchandising Services Ltd.*).

On the other hand, the creditors, who might be interested in bringing the claims, are not allowed to do so. A. Keay wrote that a party injured by wrongful trading should have the right to bring the claim to protect itself.<sup>75</sup> In our view, wrongful trading might be workable only if the injured party has the right to bring such claim and ask for a remedy which would recover the loss. It is crucial because only the party which suffered a loss is really interested in its compensation.

But the situation is different if wrongful trading should perform a punitive function. In American tort law the punitive remedy is requested by a private party, but it is considered to be punitive if the remedy is much higher than the actual loss. In Russia no concept can be punitive unless the State has the right to bring the claim. Following the same logic, in England wrongful trading might be punitive if the remedy has significantly increased or if the State has received the right to bring the claim. In the former case the private parties would be encouraged to bring wrongful trading claim even when there is a very little chance of success. In the latter case the State would almost always bring the claim and directors could be punished by a civil remedy and the disqualification order. The only question is how it would fit with the spirit of English law as in this case the civil claim is brought by the State on behalf of the private parties.

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<sup>72</sup> *Lewis v. Inland Revenue Commissioners*, [2002] B.C.C. 198.

<sup>73</sup> *Liquidator of Marini Ltd.*, *supra* n. 48; *Re Hawkes Hill Publishing Co. Ltd. (in liquidation)*, [2007] B.C.C. 937.

<sup>74</sup> It is enough to compare remedies applied in *Re Bangla Television Ltd.*, *supra* n. 46, and in *Re Continental Assurance Co. of London plc*, *supra* n. 15.

<sup>75</sup> Keay, *Wrongful Trading and the Liability*, *supra* n. 36.

## 5. Some Ideas about Possible Ways to Make Wrongful Trading Effective

In our view, wrongful trading should be defined in a way which would refer to a particular function; identification of such function by the legislature is the preliminary goal.

Ideally all interested parties should be protected by the concept of wrongful trading and the remedy for this misconduct should provide them with the full recovery of losses. To achieve that, the creditors should have the right to bring the wrongful claims as the liquidator is not able to protect all of them. The remedy should be reformed as well; the different remedies which are applied now are not fully compensatory and create the legal uncertainty. In our view, if wrongful trading is expected to be compensatory, the actual damages should be rewarded for such claims. As we discussed above, different creditors suffer different losses from insolvency trading, so the remedy should be flexible enough to meet needs of all creditors. For example, creditors who were counterparties of the insolvent company through wrongful trading can be satisfied by sums traded, but the net deficiency test is needed for creditors who were damaged just by decreasing the common pool.

The punitive function, if recognized, can be more effective using the wrongful trading remedy even in its current version; but only if the courts start ordering the remedy which would significantly exceed the losses caused by wrongful trading. As it was discussed above, while the remedy is equal to the actual losses, it is compensatory, not punitive. The court theoretically can order defendants to pay more than the sums traded or losses suffered; so, in this part the law does not have to be reformed. However, the liquidator and the creditors as whole are not interested in punitive damages; thus, for fulfillment of this function the creditors should also have the right to file the claim.

A separate question is whether the Secretary of State should be a plaintiff for wrongful trading claims;<sup>76</sup> in our view it should not. The Secretary of State is an administrative body which is responsible for the state's participation in the various business areas, including directors' disqualification. In the last case the Secretary of State files the petition and is quite successful in this.<sup>77</sup> Unlike the liquidators, who file only a couple of wrongful trading petitions per year, the Secretary of State files more than 1,000 disqualification petitions annually. It is clear that if the Secretary of State filed wrongful trading claims, it could bring them together with the disqualification petitions and in such case the number of wrongful trading claims would increase dramatically. But disqualification of directors is an entirely administrative procedure,

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<sup>76</sup> See, e.g., Andrew Keay, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish 2007).

<sup>77</sup> David Milman, *Disqualification of Directors: An Evaluation of Current Law, Policy and Practice in the UK*, 2013(331) *Company Law Newsletter* 1.

which is made on behalf of public and finished by an order prohibiting directors from performing director's functions for some time in the future. It fits with the functions and responsibilities of Secretary of State. Wrongful trading, in the contrast, is designed to protect the company, its creditors and other private parties against insolvency trading by giving them an opportunity to get a monetary remedy against the directors. It seems that if the Secretary of State had a right for such claims, it would be departing from its statutory functions<sup>78</sup> and would be a direct participation of the State in business disputes. In this case the question of remedy would increase again. Wrongful trading gives the monetary remedy; so, if the Secretary of State would file a petition on behalf of a private party, the State would decide which compensation a private party might receive. At the same time, the Secretary of State, being a part of the government, would decide whether there are grounds for directors' liability before the court did that.

It is noticeable that Sir K. Cork also wrote that different parties should be allowed to bring the wrongful trading claim and mentioned that the concept should be compensatory. In his report there was no extended discussion about remedies, but this problem appeared later in the court practice. Thus, wrongful trading is an ineffective remedy mainly because the legislature did not incorporate in the law all ideas of the concept's creator.

## 6. Conclusion

Even though the different jurisdictions have some tools for protection against insolvency trading, none of them can be called really effective.

English insolvency law contains a wrongful trading provision which imposes liabilities on directors of insolvent companies if they knowingly continued trading and did not make any reasonable steps to minimise creditors' loss; however, this mechanism is applied rarely. In our view, it happens mainly because this concept is badly-equipped to perform either compensatory or punitive functions. The key is the remedy which is applied by courts very differently. The most progressive courts use the so-called net deficiency test, but application of this test also varies, partly due to its complexity. Part of the problem, is that the law does not give protection to the creditors who suffer losses through the insolvency trading itself, but previously were not company's creditors.

The USA legislation does not have a similar provision, but creditors in the same situation sue directors under the common law concept of deepening insolvency. However, this concept covers mainly fraudulent activities of directors; negligent behaviour is recognized as a ground for deepening insolvency claim only by very

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<sup>78</sup> <<https://www.gov.uk/government/ministers/secretary-of-state-for-business-innovation-and-skills#policies>> (accessed Aug. 11, 2015).

few courts. At the same time, it is necessary to notice that American law overall is very reluctant in challenging directors' actions; it is a question of the policy.

Russian insolvency law contains a subsidiary liability provision which makes directors liable for unpaid company's debt if they did not file the insolvency petition on time. It is not used very frequently either, but there are some hundreds of such cases annually. The main obstacles to wider application of the concept are the high burden of proof and the factual requirement to file the claim at the very late stage of the insolvency procedure.

The further development of wrongful trading could overcome the mentioned problems; but it would be very difficult to do so while there is no clear understanding of wrongful trading's functions. In our view, the ideal remedy would depend on the concept's function. To be compensatory, the remedy should recover traded sums for creditors who were trading with the company through insolvency and compensate net deficiency for all other creditors. To be qualified as punitive, the remedy should be much higher than losses which were suffered by the particular creditors or the common pool. However, to perform any function the concept should give creditors right to bring the claim. Ironically, the wrongful trading remedy has to be reformed in the way originally suggested by Sir K. Cork.

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