THE RELEVANCE OF LOSS IN PREFERENCE TYPE MISFEASANCE CLAIMS – REVISITED

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Introduction

An insolvent company (A) has assets of £1,000 in cash and creditors of £10,000. One of the creditors is a connected company (B) and is owed £1,000. In disregard of the interests of the unconnected creditors, the director (C) unlawfully causes A to pay B the cash of £1,000, thereby preventing a pari passu distribution. A goes into insolvent liquidation. Can the liquidator of A bring a misfeasance claim against C for recovery of the £1,000? Or can C defend the claim on the basis that A has suffered no loss?

In 'The relevance of loss in preference type misfeasance claims' (2014) CRI 7(3), 123-124, the writer considered GHLM Trading Ltd v Maroo [2012] EWHC 61 (Ch), Re HLC Environmental Projects Ltd [2013] EWHC 2876 (Ch) and Madoff Securities Int. v Raven [2013] EWHC 3147 (Comm), and reached the conclusion, at least in relation to an insolvent company and with the caveat that it must be restoration (not augmentation):

"In light of HLC and Madoff it is suggested that in GHLM, Newey J was incorrect to say that in a preference type misfeasance claim it is necessary to prove that the company has suffered loss by reference to its balance sheet. Whether or not the claim is brought under s. 212, the obligation on the director as quasi trustee is to restore the company's fund to what it should have been. The fact that the payment of an existing debt is balance sheet neutral is not relevant: the fund held by the company has been depleted and must be restored" (the "2014 conclusion").

Nearly 10 years on, it is timely to consider whether the 2014 conclusion remains sound. Considerations of space preclude discussion of alternative relief in the form of disgorgement of profits or avoidance of the transaction in question.

Restoration, compensation and AIB

Directors are treated as being in an equivalent position to trustees. The basic rule is that a trustee in breach of trust must restore or pay to the trust estate either the assets which have been lost to the estate by reason of the breach or compensation for such loss: Target Holdings Ltd v Redferns [1996] 1 AC 421, per Lord Browne-Wilkinson at 434C-D. Such a "substitutive" claim may be distinguished from a "reparative" claim to make good damage caused by a breach of trust.

This area was the subject of controversial attention by the Supreme Court in AIB Group (UK) plc v Mark Redler & Co Solicitors [2015] AC 1503 in which AIB's claim for restoration of funds paid away in breach of trust was limited to the (much lower) loss in fact suffered. Lord Toulson held (see at [36] and [66]) that the object of an equitable monetary remedy for breach of trust, whether it be classified as substitutive or reparative, is to make good a loss in fact suffered by the beneficiaries and which, using hindsight and common sense, can be seen to have been caused by the breach. Lord Reed concurred holding at [134] that:

> ***"...the model of equitable compensation, where trust property has been misapplied, is to require the trustee to restore the trust fund to the position it would have been in if the trustee had performed his obligation."***

The "compensatory focus" of AIB led some commentators (e.g. van Zwieten (2018) 38 OJLS 382, 403)) to doubt the validity of making any restorative order against directors for preference type claims by analogy with the accounting responsibility of a defaulting trustee in circumstances where the breach causes no loss to the company.

But, as is apparent from the quote from Lord Reed above, there is no suggestion in Target or AIB that the courts were departing from the rule that a trustee was required to restore the trust fund. As another commentator has pointed out (Worthington, [2020] CLJ 220-224), the rule was never invariably "to put back the value of what had been taken out": it was "to put back the value of what should have been there". That, like in Madoff - where the company had to give credit for a benefit received from the same transaction – was what the courts were doing.

Cases below the Supreme Court

Without making reference to AIB, Newey J (as he then was) returned to this issue in Northampton BC v Cardoza [2017] EWHC 504 (Ch) when he said at [32] that the authorities tend to suggest that:

> ***"the remedies that should be granted where a director has acted in breach of duty by causing the company to prefer a particular creditor may be affected by, among other things, whether the company is in liquidation (as was the case in West Mercia and HLC, but not, much more unusually, GHLM), whether the preference consisted of the simple payment of a debt (again, West Mercia and HLC, but not GHLM), whether the creditor whose debt was to be discharged was the director himself (certain of the HLC payments)..."***

Following trial in the same case, HHJ Simon Brown QC held ([2019] EWHC 26 (Ch)) at [188] that:

> ***Returning to GHLM..., in the light of the above and to the observation that it may be impossible to show a loss where the balance sheet is unaffected, I do not understand Newey J to have meant that in all cases where the balance of assets net of liabilities remains unchanged by reversing a preference the company is unlikely to have suffered a loss. For example, the net assets figure may remain the same after restoration and a compensating adjustment to reinstate a liability to a director but the distribution of assets, notional or actual, to those entitled to receive them (creditors and contributories) may be very materially different... The remedy available to redress this 'loss' is restoration, which may be by compensation to restore the value of the assets to the trust estate."***

It is suggested that both dicta provide support for the 2014 conclusion.

The effect of AIB on misfeasance claims generally was directly considered by the Court of Appeal in Auden McKenzie (Pharma Division) Ltd v Patel [2019] EWCA 2291 when allowing an appeal against an order for summary judgment awarding equitable compensation against a director. The relevant claim was for misappropriation of funds for no value. The defence was that, if the misappropriation had not occurred, the funds would have been lawfully transferred to the same persons for no value, so no loss had been incurred. This raised the issue of the relevance (if any) of counterfactual situations which the Court – perhaps somewhat reluctantly – concluded should be decided at trial following further argument.

Relevantly in the context of the present discussion, David Richards LJ (now Lord Richards) noted at [38] the importance of the decisions in Target Holdings and AIB, but said it was necessary to be clear as to the qualification established by those cases. After further analysis, he held at [49] that:

"While [those cases] establish that equitable compensation in respect of unauthorised payments is not invariably for a sum equal to the payments, the decisions in those cases provide no further direct assistance to Mr Patel's case. They are restricted to circumstances where the beneficiary obtained the full benefit for which it bargained or where, if the trustee had fully performed its obligations, the loss would have been less than the amount of the unauthorised payment made by the trustee. In each case, the reduced figure is the loss that flowed directly from the breach of trust."

Although Auden did not concern a preference type claim, it is apparent from the above (and the example given by the Judge at [53]) that he did not consider that Target Holdings and AIB precluded substitutive claims for misfeasance "measured by the amount misappropriated" in circumstances where hindsight and common sense showed the breach had caused the trust fund such a loss.

In Mitchell v Al Jabar [2023] EWHC 364 (Ch), Joanna Smith J confirmed at [561] that "The core message of the judgments in AIB...was that a trustee is required to restore the trust fund to the position it would have been in 'if the trustee had performed his obligations'" and at [563] that, on the facts before her, "...I can see no justification for a departure from the strict obligations of trustees and fiduciaries to restore the fund under their control, always assuming that the breach...can be seen with hindsight and common sense to have caused the loss".

In both cases the Judges were referring to a loss to the trust fund, not to loss and damage in a strict balance sheet sense, as would be the test in a purely reparative claim whether for breach of fiduciary duty, or in contract or tort.

Supreme Court Dicta

The facts and decision in BTI 2014 LLC v Sequana SA [2022] 3 WLR 709 are well known. But there has been limited focus on Lord Reed's discussion of s.239, IA 1986 and its relationship with misfeasance claims at [100]-[109]. As part of his reasoning on the existence of the West Mercia (or creditor) duty, he held at [109] that the existence of s.239 was not incompatible with it.

Although not directly arising for decision, Lord Reed also noted some of the issues that had arisen in the cases (including West Mercia itself, GHLM, Re HLC and Northampton BC) as regards the basis of relief in preference type misfeasance claims. At [104], he referred to the decision in West Mercia to order the director who had authorised a preference payment to a third party to repay the amount of the preference subject to inclusion of that debt in the amount of the company's liabilities with any dividend attributable to that debt being paid to the director (i.e. the West Mercia proviso). At [105] he said:

"My provisional view is that the court was correct in taking that approach to the question of relief. In order to obtain a pecuniary remedy, it was not necessary for the company to have suffered a loss in the conventional, balance sheet, sense. The funds available to the company to meet the claims of the general body of creditors were depleted as a result of the director's breach of his fiduciary duty. The court granted an equitable remedy, based on the restoration of the misapplied monies to the company so as to reconstitute its assets as they ought to have been. By doing so, and treating the debt as subsisting for the benefit of the director, the court achieved the equivalent, as nearly as possible, of the directors performance of his fiduciary duty to the company."

It is therefore clear that Lord Reed, who had himself given one of the two substantive judgments in AIB, did not regard that decision as any form of bar to substitutive relief arising from a preference type misfeasance claim by an insolvent company.

Shortly after Sequana, the Supreme Court handed down judgment in Stanford International Bank Ltd (in liquidation) v HSBC Bank Plc [2022] UKSC 34. The majority (Lord Sales dissenting) rejected SIB's tortious claim against HSBC for breach of the Quincecare duty on the basis that the £116m paid out as a result of breach, discharged debts owed to customers and hence there was no recoverable loss. It was not a claim for breach of fiduciary duty, but some obiter references were made to such claims and questions of remedy.

Lady Rose (with whom Lords Hodge and Kitchen agreed) distinguished the case before her with that in West Mercia. At [34] she accepted that:

"...there may well be situations, similar to West Mercia, where a director is properly regarded as

misfeasant and required to repay sums to the insolvent company even though those sums have been used to extinguish an existing liability...I do not accept that a decision that no recoverable loss is suffered by SIB in this case undermines the ability of the court of equity to identify a case of misfeasance and fashion an appropriate remedy, as the Court of Appeal did in West Mercia."

In his dissenting judgment at [122], Lord Sales described the approach in West Mercia as "sensible and justified" and said at [123] that the obligation of a fiduciary to make good the trust fund from which he has diverted money is to make good a loss "in the fund which has been created by the diversion of money from the proper use to which it should have been put".

Lord Leggatt took a different approach. After referring to West Mercia, Re HLC and AIB, he said at [75] that it was hard to see how, in the absence of loss to the company or gain to the director, a director who caused a preference type payment to be made "which does not meet the criteria for an unlawful preference" could properly be liable to repay the money. He suggested, without expressing any concluded view that:

"Requiring the director to repay the money in such a case would cut across the distribution of assets provided for by the insolvency regime. It would also impose on the director a liability for which he or she (despite not having personally received a benefit) would not even in principle be entitled to an indemnity from the person who received the money. That would not be just."

Although any dicta of a Justice of the Supreme Court merits careful attention, it is apparent that Lord Leggatt holds a minority (provisional) view amongst the Justices who have recently considered this point. Further:

- Lord Reed specifically rejected the argument that s.239 was incompatible with the creditor duty, a form of which was relied in West Mercia as giving rise to the preference type claim against the director.
- It is not at all clear why it would be unjust for a director to restore (subject to the West Mercia proviso) funds misapplied by a preference type payment to the detriment of other creditors, any more than it would be unjust for him or her to restore funds paid to a third party for no consideration.

- The legal existence of a claim under s.239 against the third party can surely not be determinative; if it is insolvent then the claim is of no practical relevance.

Conclusion

Whilst this area of law would benefit from detailed attention by the higher courts, it is suggested that the direction of travel remains firmly in favour of the 2014 conclusion.

In the example given above, if the director had performed his duty, the company would have retained the cash of £1,000 and the creditors would have received a pari passu distribution accordingly. The misappropriation of the £1,000 is properly to be regarded as "a loss to the trust fund which the trustee has brought about" (per Lord Toulson in AIB at [65]) and restoration is "likely to be the only way to put the beneficiaries [i.e. the creditors] in the same position as if the breach had not occurred" (ibid at [67]).

It is in accordance with principle and authority for the director to be required to restore the £1,000 to the estate, subject to the West Mercia proviso. Indeed, that should be the conclusion whether the recipient was the director himself, a connected third party or an unconnected third party, albeit the latter may raise more difficult questions on the facts as to breach of duty.