Southill Finance Limited (in Liquidation) – looking back in anger

A recent case throws light on how far conventional time periods of investigation may be stretched where losses are concerned.

The current climate

It has been 17 years since the end of the last official recession during which time, barring the dot.com collapse, companies around the world have experienced unprecedented growth. During a boom, few people complain about the handling of companies that generated high returns. However, as the boom recedes and finances become stretched, losses come to light from actions that may have occurred many years in the past. The passage of time will have taken many of these actions beyond conventional limitation periods and out of the scope of insolvency recovery actions. The recent case of *Southill Finance Limited (in Liquidation)* [2009] EWCA Civ 2 provides a timely reminder that, in certain instances, the limitation period may be extended. Here, the applicants sought to challenge actions of the finance director dating back to the 1980/90s, a number of years before the company was wound up and more than 15 years before the case was heard.

Actions available to swell the insolvency estate – look-back periods

The insolvency of a company triggers a number of potential actions under the Insolvency Act 1986. This gives the opportunity to challenge and avoid transactions at an undervalue (s238) and preferential payments to creditors (s239) and to launch actions for fraudulent (s213) or wrongful (s214) trading.

However, preferential payments may only be set aside if they take place within the six months prior to the onset of insolvency, or two years if to a 'connected person'. Transactions at an undervalue must similarly have been entered into up to two years prior to the onset of insolvency. Both actions must be brought within six years of the company entering administration or liquidation.

A claim for fraudulent trading may allow a liquidator to look further back to a time when it appeared that the company had been carried on with the intent of defrauding the creditors of the company. An example would be a transaction, the effect of which was, to the knowledge of the director at the time of the transaction, ultimately to leave the company unable to pay its creditors. A liquidator of a company that was cash rich in a boom period may, however, be hard pressed to prove that a director had this knowledge. An action for wrongful trading involves establishing that at a point in time prior to the commencement of the winding up of the company, a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. There is no maximum look-back period, although in practice it may be difficult to establish the relevant knowledge more than a few months prior to the liquidation. Actions for fraudulent or wrongful trading must be commenced within six years from the date of the liquidation.

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Section 423 (Transactions defrauding creditors) Insolvency Act 1986 allows a victim to challenge a transaction entered into at an undervalue:

(i) for the purpose of putting assets beyond the reach of a current or future creditor of the company; or

(ii) which is otherwise prejudicial to the interests of such a person in relation to a claim which he is making or may make.

A liquidator or administrator may bring the action on behalf of the creditors of the company who were collectively the victims of a transaction. There is no limit on how far back in time you can go, and nor is it necessary to establish that the company was insolvent at the time. However, it will be necessary to establish that the defendant was motivated to put assets beyond the reach of creditors or that his or her actions were prejudicial to potential creditors. If the company was solvent at the time, the latter requirement may be difficult to satisfy.

Southill Finance concerned a claim under s212 (Misfeasance) Insolvency Act 1986. This provides any creditor, official receiver or liquidator with the power to apply to court where an officer of the company has misapplied or retained any money or other property of the company or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company. It is not necessary to establish that the company was insolvent at the time. The court can examine the officer's conduct and make an order for him to repay money, restore property or contribute to the assets of the company. Actions of this nature are ordinarily brought by the liquidator rather than the creditors themselves, as any award goes to the benefit of the creditors as a whole.

Section 212 provides a simpler procedure than ordinary civil proceedings for the recovery of property or compensation on the company's winding up but, importantly, does not create a new cause of action. A cause of action under existing law will need to be established, for example, a breach of duty of care or breach of trust. Accordingly, an action under s212 is subject to the same limitation as the underlying cause of action. Where the relevant events took place more than six years prior to the winding up, an action under s212 may not therefore be available to the liquidator or creditors.

Overreaching the limitation period

The limitation period is intended to provide a defendant with a procedural defence to a stale claim; a claim with which he never expected to have to deal. However, the Limitation Act 1980 provides that no limitation period shall apply to an action by a beneficiary under a trust, being an action:

- s21(a) in respect of any fraud or fraudulent breach of trust to which the trustee was a party or privy; or
- s21(b) to recover from the trustee trust property or the proceeds of trust property in the possession of the trustee, or previously received by the trustee and converted to his use.[1]

Southill Finance is a case where the applicant sought to bring proceedings in relation to breaches of duty which would ordinarily have been time-barred. The case is also of note because the application under s212 was brought by a creditor of the company and not the liquidator.

The facts of the case

Southill Finance Limited (Southill) was incorporated in 1984, as the finance vehicle to a group of companies specialising in subsidence control (the Southill Group) of which Mullarkey and Broad were directors and ultimate owners. Mullarkey alleged that over the course of the late 1980s Broad had, in fraudulent breach of his fiduciary duty as a director, come to use Southill as a vehicle to transfer property and provide unauthorised loans to himself and companies under his control outside of the Southill Group that were never fully paid or disclosed on liquidation.

Southill had ceased to trade in 1993 and was wound up in 1995. The liquidator had reported to the Official Receiver that despite his suspicions he had not found any evidence of wrongdoing. Mullarkey therefore brought the claim, acting as a creditor of Southill under an assignment of debts by Southill Group subsidiaries, seeking an order against Broad pursuant to s212.

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The limitation issue

Mullarkey accepted that the limitation period would be a complete bar to the claims as the relevant breaches of duty had taken place more than six years before Mullarkey made his application but he relied in the first instance on s21(a) of the Limitation Act 1980 – stating that Broad had acted in fraudulent breach of trust. No argument was made in relation to s21(b) – recovery of trust property. On his own case, despite prompting from the judge, Mullarkey therefore had to establish fraud or the limitation period would provide a defence to the claims against Broad.

The case was hampered by the passage of time and the incompleteness of evidence but the judge did find that Broad had received loans in breach of the Companies Act 1985, which were not repaid or disclosed on the winding up. However, the judge found insufficient evidence that Broad had used his powers in a way that established fraudulent breaches of duty. Broad's actions were not inconsistent with the possibility of honest conduct or inadvertent action rather than deliberate or reckless fraudulent conduct. Accordingly, Mullarkey had not satisfied s21(a) and so the claim was time-barred. On appeal, Mullarkey sought to change his claim and argue that no limitation period, applying s21(b) Limitation Act 1980. The court was concerned that at trial, evidence necessary to enable the court to determine whether this section was made out had not been put before the court in the first instance and refused to allow the appeal.

There may be alternatives

There are inherent practical difficulties in reaching back in time and challenging historic actions. In the case in question, the working papers of the auditor had been destroyed, the records were incomplete and the participants' recollections were hazy. However, if Mullarkey had from the outset based his case on both limbs of s21 Limitation Act 1980 and been able to prove the relevant elements of the claim and of those provisions, he may have succeeded in extending the limitation period and obtaining an order that funds be repaid. Setting aside practical difficulties, the same set of facts may give rise to a number of alternative lines of attack. In considering which to pursue regard should be had to the relevant limitation and the timing constraints. In addition, where the liquidator cannot or will not bring proceedings, there may be matters that can be pursued by others affected by the actions in question. ☐

[1] Section 32 provides an additional exception where the defendant has fraudulently concealed his action from the claimant but this was not argued in *Southill*.

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