Corporate Social Responsibility in an Insolvent Environment: Directors’ Continuing Obligations in English Law

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Abstract

This paper critically examines Corporate Social Responsibility (CSR) in an insolvency context. The paper is divided into three parts. First, we examine the area of CSR generally. Secondly, we consider directors’ obligations to creditors in both a solvent and insolvent context. Thirdly, we examine directors continuing obligations to stakeholders during a formal insolvency process. This three-pronged analysis allows us to consider whether directors still owe CSR type obligations whilst a company is going through a formal insolvency procedure pursuant to English and Welsh law. It is this crossover between CSR and insolvency which is examined in part three of the paper. It is argued that directors continue to owe duties to creditors during an insolvency procedure but that they may also continue to have obligations towards wider stakeholders, including those that fall under the realm of CSR. It is argued that this continuing CSR responsibility evidences how ingrained CSR concepts now are in English and Welsh law.

Introduction

Corporate Social Responsibility (CSR) has for some time been recognised as a key component of English and Welsh corporate law and practice. Drawing on international approaches¹ the concept is now to some extent reflected in English and Welsh law.² Similarly, directors’ continuing obligations to various stakeholders, both in a solvent environment and whilst a company is going through a formal insolvency process, also have a fairly long heritage.³ This paper examines the concepts of CSR

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¹ See for example the famous interchange between Professors Berle and Dodd, starting with: M. Dodd. For Whom are Corporate Managers Trustees? (1932) Harvard Law Review, 1932 vol. 45 no. 7: 1145–1163.
and insolvency against the backdrop of the recent global “credit crunch.” The paper is divided into three parts. First, we examine the area of CSR generally. Secondly, we consider directors’ obligations to creditors in both a solvent and insolvent context. Thirdly, we examine directors continuing obligations to stakeholders during a formal insolvency process. This three-pronged analysis allows us to consider whether directors still owe CSR type obligations whilst a company is going through a formal insolvency procedure pursuant to English and Welsh law. It is this cross-over between CSR and insolvency which is examined in part three of this paper. It is argued that directors continue to owe duties to creditors during an insolvency procedure, but that they may also continue to have obligations towards wider stakeholders, including those that fall under the realm of CSR. It is argued that this continuing responsibility evidences how ingrained CSR concepts now are in English and Welsh law.

1. Corporate Social Responsibility

CSR is a very broad subject by its nature, ranging from community relations to sustainable development. It is important, under the principles of CSR, to conduct the business of a company in an economically, socially and environmentally responsible manner. CSR is a “concept whereby companies integrate social and environmental concerns in their business operations and interaction with their stakeholders on a voluntary basis.” More often, its meaning is expressed in “moralistic catchwords”, as well as basic definition statements such as “human dignity, equality, and the social good”, although these definitions might themselves be unclear and subjective. Making corporations engage in good CSR policy is another advantage in adopting stakeholder theory. CSR can contribute to a number of social environmental and economic policy objectives. What good CSR policies can bring includes “the advisements of competitive advantage, better reaching market segments like ethical consumers and socially responsible investors and enhanced opportunities for strategic alliance or other partnership as major business opportunities for

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6 W.C. Frederick, ‘From CSR1 to CSR2 — The Maturing of Business and Society Thought’ (1994) 53 Business and Society 51.
corporations with external constituencies, and, for an internal point of view, enhancement of labour rations and employee commitment, and the achievement of overall better financial and strategic results." It is recognised that one major development in the market sector in the last twenty years, i.e. the rapid growth of CSR and socially responsible investment performance of institutional investors, has had the practical effect of bringing social, environmental and ethical concerns into the realm of Anglo-American corporate governance.

The CSR movement has been a major factor in moving corporate governance theory in the direction of a stakeholder model by requiring companies to go beyond the creation of short-term shareholder wealth in pursuit of broader objectives such as sustainable growth, equitable employment practices, and long-term social and environmental well-being. There is evidence that businesses of all sizes are taking CSR seriously. The triple bottom line of CSR is taken as a point of departure, focusing on people and planet dimensions, in particular human rights, labour rights and environmental protection. CSR is often divided into four areas: workplace, market-place, environment and community although there areas inevitably overlap in practice. Effective CSR requires dialogue and partnership with stakeholders such as trade unions, public authorities, non-governmental organisations, and business representative organisations.

The recent growth of institutional investor activism in social investment in the UK has been regarded as a leading initiative in Western countries. CSR is not so much

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about the enterprise do with their profit, but how they make that profit. Almost eighty percent of UK pension scheme members now require their schemes to operate a social investment policy. In May 2002 the Department of Trade and Industry (DTI) published its first report on CSR. In the report, the DTI defined CSR in the following terms:

“a responsible organisation does three things: (1) it recognises that its activities have a wider impact on the society in which it operates; (2) it takes account of the economic, social, environmental and human rights impact of its activities across the world; (3) it seeks to achieve benefits by working in partnership with other groups and organizations.”

Directors of socially responsible companies have a network of related duties towards various stakeholders. For a socially responsible company, it is important to ensure diversity in the workforce and provide suitable conditions for employees; it is also crucial to minimise the impact of products and process on the quality of land, air, water and the ecosystems that make up the environment, and to maximise the positive impact of the companies’ operations through support for and involvement in the local communities where it operates.

It is acknowledged that the law limits the ability of businesses to maximise their profits at the expense of others. For example, elaborate legal provisions are designed to ensure that consumers are not misled, the health and safety conditions of employees are not in danger, and excessive damage to the natural environment is avoided. In other words, moral, environmental or social policy interests should not be overridden in the pursuit of private commercial gains. If company directors take social responsibilities into account, it becomes more sensible to define the ultimate purpose of directors’ duties as “maximisation of the total creation of wealth”.

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17 As it then was, now the Department for Business, Innovation and Skills (BIS).  
18 See s.172 Companies Act 2006.  
example, if a company director focuses on local employment problems as a corporate strategy and the problems are virtually eliminated as a consequence, local government and the local community will pay more attention to this company and give them a more favourable investment environment, hoping to encourage further local investment and to settle more local social problems. The employees will also trust the company and be willing to work there because of its respected local reputation.

If we view this problem in a broader sense, CSR is also helpful to companies’ performance in achieving their social objectives based on participatory social policies. Carroll has suggested that one way of assessing the social performance of companies is to measure the social objectives they implement. Social audit systems and financial accounting procedures are two means of assessing corporate social performance. Specifically, they measure the social performance of a company, including employment opportunity programs, conditions of work in the workplace, pollution control, job satisfaction and the quality of working life, the ethical performance of corporate executives and community and urban redevelopment programmes. Local government makes frequent assessments of corporate social performance in order to promote and monitor the status of directors’ duties in term of their CSRs. Meanwhile, the media and other related organisations will regularly publish the results of such assessments, which can have a significant impact on the reputation and development of the company.

CSR, which is still often of a voluntary nature, largely parallels the concept of “stakeholder theory”, which emphasises the intertwined relationship between enterprise and individuals and organisations larger than the ones traditionally accounted for by businesses and professionals. CSR is able justify its existence since it has successfully proven how social and environmental corporate engagement can substantially benefit society and the enterprise itself. The adoption of stakeholder theory seems to be a logical step towards the development of more ethical corporations.

It is against this backdrop of CSR imbued directorial behaviour that we can now consider the directors’ relationship with creditors generally.

2. The Nature and Scope of Directors’ Duties towards Creditors

Since the judicial acceptance of the company as a separate legal entity it is a clearly established rule that directors must exercise the power given by company law as fiduciaries for the company as a whole without negligence and not for any collateral purpose. Early authorities also held that directors owed their duties to the company as a global whole, i.e. an amalgam of shareholders, and that their focus should be directed towards shareholder wealth maximization. Therefore according to traditional ideas, the directors did not owe duties to other parties, such as employees or creditors.

This position has caused much debate, both judicial and academic. The academics began to advance the idea of extending the directors’ duties. Professor Sir Otto Kahn-Freund QC pioneered thinking in this area when he brought forward “three

28 The principle established since the frequently cited classical case Salomon v A Salomon & Co. Ltd [1897] AC 22
30 Re Smith & Fawcett Ltd [1942] Ch 304 at 306; [1942] 1 All ER 542 at 543.
31 Percival v Wright [1902] 2 Ch 421.
32 Hutton v. West Cork Railway Co Ltd (1883) 23 Ch Div 654.
33 see; Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd [1983] Ch 258 (‘Multinational Gas’); Grove v Flavel [1986] 43 SASR 410, 417 (Jacobs J); Peskin v Aderson [2000] BCC 1110 (and affirmed on appeal by the Court of Appeal (14 December 2000). Also see the comments of the Jenkins Committee, Cmnd 1749 (1962) at para 89
social and economic needs to which a system of company law should respond\textsuperscript{34}, namely, shareholder protection, the interests of the community and the outside creditor.\textsuperscript{35} It has also been held in a large number of academic articles, in Commonwealth countries and the United States, that in certain circumstances it is mandatory for directors, in discharging their duties to their companies, to take into account the interests of their companies’ creditors.\textsuperscript{36}

Judicially, since the classic dictum of Mason, J in \textit{Walker v Wimborne}\textsuperscript{37} that “directors of a company in discharging their duty to the company must take account of the interests of its shareholder and creditors\textsuperscript{38}, courts in commonwealth countries have “elevated this ‘almost casual’\textsuperscript{39} statement to become a ‘regular\textsuperscript{40} and sometimes ‘radical\textsuperscript{41}, feature of the topography of modern company law.”\textsuperscript{42} Since 1929, English company law has contained provisions whereby directors can be personally liable for debts of the company which has gone into liquidation where the affairs of the company have been conducted so as to defraud the company’s creditors or member,

\textsuperscript{34} O. Kahn-Freund ‘Some Reflections on Company Law Reform’ (1944) 7 Modern Law Review 54
\textsuperscript{35} About balance of these interests see A. Keay, ‘Balancing Interests in Bankruptcy Law’, (2001) Common Law World Review, 206
\textsuperscript{37} [1976] 137 CLR 1
\textsuperscript{38} Ibid at 7
\textsuperscript{39} R. Baxt, ‘A Senior Australian Court Gives the Thumbs Up to the Winkworth Principle---Directors Owe a Duty to Creditors Both Present and Future’ (1989) 7, C&SLJ 344
\textsuperscript{42} A. Hargovan, ‘Directors’ Duties to Creditors in Australia after Spies v The Queen---Is the Development of an Independent Fiduciary Duty Dead or Alive’, (2003) 21 C&SLJ 390 at 392
or for any fraudulent purpose.⁴³

Numerous academic commentators have commented on this creditor based duty over the latest twenty years. However, the nature and extent of the duties owed by directors to their creditors are always obscure areas and needed in depth research, particularly in relation to how directors should respond to their CSR functions when operating in an insolvent environment.

Before we move to that question we will now consider the nature of directors’ duties to creditors; before going on to discuss the extent of the duties; finally we will examine some areas for legislative reform in this area.

2.1 The nature of the Duties Owed by Directors to their Company’s Creditors

2.1.1 General Nature

Directors have various duties that fall within the scope of two main areas. They “must act bona fide in what they consider to the best interests of the company”⁴⁴ when exercising their directorial powers, and, they must perform their duties with a certain degree of skill and care which is reasonable according to their knowledge and experiences.⁴⁵ This second duty is now reflected in section 174 Companies Act 2006. The key element in the picture of directors’ duties hinged on the fundamental requirement that directors shall act in good faith in what the director, not the court, considers is in the interest of the company.⁴⁶ When it comes to the directors’ duties related to creditors, the duty primarily requires, if it does exist, for directors to protect the interests of creditors and that they will be personally liable for the breach. This duty becomes specially distinct when the company is insolvent, near insolvent or there is some uncertainty over the company’s solvency and where it is unable to

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⁴³ The relevant Provisions are now s. 213 of the Insolvency Act 1986 and s. 458 of the Companies Act 1985. – 2006 act equivalent???
⁴⁴ Take Corporation Ltd v Millar [1972] 33 DLR (33) 288
⁴⁶ Re Smith and Fawcett Ltd. [1942] Ch. 304. These general duties owed by creditors have been discussed very clearly in the leading text books and cases and it is not necessary to discuss in detail here since is essay is more focus on the directors’ duty in relation to creditors.
discharge its debt due to the reason that interests of creditors will begin to outweigh those of the general body of shareholders under these circumstances.\(^\text{47}\)

### 2.1.2 Source of the Duty

While Cooke, J. thought tort to be an appropriate starting point for the genesis of this duty,\(^\text{48}\) Lord Templeman in the *Winkworth* case\(^\text{49}\) stated that the duty is merely a development of the fiduciary duties imposed on directors to the company as a whole.\(^\text{50}\) Also in the *Hilton* case Tipping, J. still seemed to regard the matter as one of directors’ fiduciary duties to the company. In some academic writing, equality is regarded as judicial source of the duty.\(^\text{51}\) Equity has the advantage of extending the existing law therefore it seemed to be the basis on which most cases are decided.\(^\text{52}\) Another possible source worth is the statutory scheme of creditor protection\(^\text{53}\) in which to protect creditors’ interests as parts of the companies’ interests.\(^\text{54}\) But this rationale is contrary to the principle that the creditors’ interests just step into and are regarded as the companies’ interests when the company is in insolvency state. Therefore, equality seemed to be the most acceptable idea and “cases can stand as mere application of statute—misfeasance of a statutory injunction against improper decisions”\(^\text{55}\) according to that principle.\(^\text{56}\)

If there is a duty owed by directors to creditors, a question arises on the nature of the duty – namely - is the duty a direct duty or a duty mediated through the company? That is to say a clear distinction has to be drawn between saying that a director owes a fiduciary duty to a creditor, and saying that a director has a duty to consider the interests of creditors. The former duty implies that the creditor can enforce that duty

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\(^\text{48}\) Nicholson v Permakraft (N.Z.) Ltd. [1985] 1 N.Z.L.R. 242

\(^\text{49}\) *Winkworth v Edward Barton Development Co Ltd* (HL 1986) [1987] 1 All ER 114

\(^\text{50}\) [1988] 4 NZCLC64.721


\(^\text{52}\) D.A. Wishart, ‘Models and Theories of Directors’ Duties to Creditors’, (1991) 14, NZULR 323, at 333


\(^\text{54}\) This kind of nature will be further discussed in the part 2.6 Reason of the Nature


\(^\text{56}\) D.A. Wishart, ‘Models and Theories of Directors’ Duties to Creditors’, (1991) 14, NZULR 323, at 333
himself; and a duty is owed to the company and enforced by the company alone in the latter one, \(^{57}\) usually on the company’s behalf by its liquidators. \(^{58}\) In *Winkworth* \(^{59}\), Lord Templeman seemed to indicate in clear terms that the duty to consider the interests of the creditors was owed not only to the company but also to the creditors themselves. \(^{60}\) But in the case *Yukong Lines Ltd of Korea v Rendsburg Investments Corp* \(^{61}\), Toulson, J. rejected the notion of a direct duty being owed to creditors that was approved in Australian court. \(^{62}\)

Professor Andrew Keay has explicitly pointed out that “rather the duty is an indirect one in that it is owed not to creditors but to the company to consider creditor interests.” \(^{63}\) Professor Len Sealy asserted that the duty owed by the director is only “indirectly through a liquidator acting on behalf of the company that the creditors interests are represented.” \(^{64}\) Professor Dan Prentice argued that the duty should be mediated thorough the company. \(^{65}\) And he also gave three strong reasons for it: First, “it eliminates any problems of double recovery”; secondly, it preserves the (so-called) \(^{66}\) most important principle in insolvency law, namely, *pari passu* principle \(^{67}\); thirdly, it “preserves the procedural monopoly of liquidation proceeding for dealing with the claims of creditors against an insolvent company”. \(^{68}\) This will require the liquidator to undertake the action to enforce the duties on behalf of the company as a whole that goes insolvent. If the duties were direct, namely every single creditor can claim for compensation from directors directly, it would be hard to imagine the position of unfortunate poor directors, who would be incessantly paranoid about creditor.

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58 A. Keay, ‘Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors’, (2003) 66, *Modern Law Review*, 665, at 670; of course the unsecured creditors seemed to be able to enforce duties of the directors by liquidation while secured creditors can also do that by administrator and receiver.  
59 *Winkworth v Edward Barton Development Co Ltd* [1987] 1 All ER 114  
60 *Winkworth v Edward Barton Development Co. Ltd (HL 1986)* [1986] 1 WLR 114, at 118  
61 For example, the *High Court in Spies v The Queen* [1998] 2 BCLC 485  
65 D.D. Prentice, ‘Creditor’s Interests and Director’s Duties’ (1990) 10 OJLS 265, at 276;  
2.1.3 The Rationale for the Duties’ Existence- Shift of the Duties?69

The recurrent theme in equity jurisprudence appears in some cases70 illuminated that the existence of directors’ duties in relation to creditors is due to the proposition that creditors are as beneficially interested in the company when the company is insolvent or marginally insolvent as previous interested parties in a time of solvency.71 This suggests that directors’ duties in relation to creditors are dependent on the creditors “having a proprietary interest in the assets of the company, or being prospectively entitled to such a right in a ‘practical sense’.”72 It could be argued that such an argument is fundamentally wrong because although the creditors are entitled to step in when the company goes into an insolvency procedure, it does not mean that creditors have the concurrent acquisition of a proprietary interest in the assets of the company.73 This means creditors are unable to take, at random, what they want from the assets of the company simply because the company which is going to be, or is in an insolvent condition, owes them money.

Unlike the recurrent theme in equity jurisprudence, Professor Andrew Keay has deployed a strong argument on the rationale of the duties when he pointed out that the duty discussed here is:

“a form of creditor protection, in habiting companies externalising the cost of their debts at the time of financial distress”75 and when the company is insolvent or in the vicinity of solvency the “doctrine of limited liability shifts the risk of failure from the shareholders to the creditors, …. and the duty is a way of compensating unsecured creditor from whom liquidation is frequently

69 The rationale of shit of duties from shareholders to creditors is described as ‘creditors maximisation’ and ‘true shit’ by American Scholars comparing with ‘entity maximisation’ and ‘shareholders maximisation’. The classification is generated by a famous footnote from Chancellor Allen who set standard in organising structure for any efficiency analysis in the corporate distress context
72 Kinsela v Russell Kinsela Pty Ltd [1986] 4 NSWLR 722, 730 per Street C.J.
74 ibid, at 141
This idea is also held by Professor Jonathan C. Lipson when he said that “once a corporation is in financial distress, duties of care and loyalty that ordinarily run solely to or for the benefit of shareholders ‘shift’ to corporate creditors.” The reason of shifting is when the company is insolvent, near insolvent or embarking on a venture the directors and shareholder have nothing to lose and the interests of the company are fully subject to the interest of the creditors. At this moment, the shareholders’ ownership on residual value of the company is supplanted by the creditors (whose rights are turned into equity-like rights) and the creditors may be regarded as the major stakeholders in the company.

2.1.4 Redistributive Duty?

When discussing directors’ duties to creditors a comparison should always be made between the position of the beneficiaries of the directors’ duties before and after the debtor firm becomes subject to a distinct insolvency regime. This exercise should be undertaken in order to judge if the directors’ duty is in some way redistributive. It has been argued by Professor Riz Mokal that the duties “are redistributive if they give to those whose interests they serve a claim against assets they would not have under the general law.” The directors’ duty discussed here are redistributive according to this norm since the position of the creditors are distinct before and after the duties owed by the directors step in. After the duty is triggered, the creditors are enjoying a fresh

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82 A. Keay, ‘Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-
kind of right to bring a claim in relation to assets of directors which they would not have under general law. The redistribution of the duty imposes the personal liability on the directors if they make any wrongful decisions that lead to further loss to their company’s creditors.

Since the redistributive nature of the duties owed by the directors to the creditors makes the directors responsible for the creditors independently and individually, the advantage of this kind of duty for the creditors is there is a chance that some money can be compensated from the directors if the company ends up in insolvent liquidation. The directors of the company, if the company is financially distressed, will use their discretion in favour of the creditors threatened by the legal proceedings in the future. The disadvantage is, in our view, that the directors have to again use their discretion to decide when the duty triggers, which is difficult to judge. The directors, while explicitly aware that they might be held responsible for the debt with their belongings, will find themselves overindulged with the concerns of their liabilities to the creditors to the extent of overlooking the interests of shareholders even while the company is solvent.

2.1.5 Rationale for the Duty

We can argue, from another angle, that the duty owed by directors to creditors is a form of creditor protection to ensure that the creditors will get their money back when the company gets into financial difficulties. If the creditors are not properly protected, it will result in systemic trouble in the financial system due to certain kind of chain reaction. What is more, the company owes a duty to its creditors to keep its

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85 Ibid
86 More discussion in Part 3: the extent of the duties owed by the directors in relation to companies’ creditors.
87 This might make the creditors drop the more important duties, namely the duties of the shareholders, while pays too much attention to the creditors in the panic of personal liabilities.
property inviolated and available for repayment of its debts. Special attention should be paid to unsecured creditors who are only protected by contractual rights and always get very small (if non-existent) amount when the company goes into liquidation. Their interests should be protected by the directors by “some form of fiduciary protections”. Therefore the directors should, at this moment, do their best with their skills, experiences, and knowledge to “externalise the cost of the company’s debt”.

It was argued that “creditors could suffer harm where the company unilaterally increased the risk” and the greatest protection will be provided from the duty of the directors at the time of greatest risk. The board of the company should try to prevent the “profligate use of corporate power to incur liabilities.” In reality, it is one of creditors’ bearing risks which creditors have not agreed to take on transferring from the shareholders. Therefore, it will be unreasonable for the creditors to be liable for the risks and directors should step in on behalf of the company to protect the creditors.

2.1.7 Ex Post Nature

Unlike the contractual duties owed the buyer and seller in sale of goods contract, the directors’ duties in relation to creditors are provided in an ex post nature. That means since creditors are seldom required to sign up to certain terms in the creditor contract it might be unfair for the directors to be held liable for the actions that they

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89 Winkworth v Edward Barton Development Co Ltd [1987] 1 All ER 114
90 For a more detailed argument on directors and unsecured creditors, see V. Finch, ‘Directors’ Duties: Insolvency and the Unsecured Creditors’ in A Clarke, Current Issues in Insolvency Law, London: Steven & Sons (1991)
94 Ibid
95 McPherson, ‘Duties of Directors to Shareholders and Creditors’, Legal Research Foundation, seminar, Auckland 1989, see page 14
are not supposed to do before appointment and not covered by the credit contract. But as a matter of fact, the duties still step in “at some time after the contracts have been finalised”. Similar situations are discovered in other law areas, such as “open price contract” in sale of goods and the power to adjust transaction at an undervalue in insolvency law. English law does not refrain from imposing responsibility ex post. But the uncertainty of this kind of responsibility will definitely cause many uncertain aspects in enforcing the law as the directors will constantly get confused and have too much discretion, which he or she might not be willing to process.

2.2. Extent of the Duties Owed by Directors in Relation to their Company’s Creditors

After obtaining a clear idea of the nature of the duties owed by the directors to their company’s creditors, it is crucial to define the extent of the duties. Before discussing this, one should be aware that the directors would still be responsible for the company as a whole before an office-holder is appointed to fill in for the director and the board to manage the company. Therefore, although directors are required to stop from their activities in relation to continuing to trade while companies are on the slide into liquidation or the directors knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation, their duties do not vanish along with their ‘replacement’ by an insolvency practitioner office-holder. Directors still have to take care of the company with their skill and care. Cooke, J noted several examples that may require the directors to consider inter alia the interests of creditor namely “if the company is insolvent, near-insolvent, doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.” The examples are just given in a enumerated way, the discussions below are going to clarify the judicial thinking about extent of the directors’ duty to

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98 Ibid
99 See Section 8 of Sale of Goods Act 1979
102 Section 214, Insolvency Act 1986
103 Nicholson v Permarkraft (NZ) Ltd [1985] 1 NZLR 242 at 249
consider, namely, to whom are the duties owed which is based on a function either of the occurrence of a certain event (for example, liquidation) or of the development of a financial condition (for example, insolvency)\textsuperscript{104}; and the time when the duties trigger in which is based on function of concerns about efficiency\textsuperscript{105}.

2.2.1 To Whom are the Directors' Duties Owed?

The traditional view of English company law denied directors' duties to third parties dealing with the company, such as its creditors.\textsuperscript{106} But the adverse idea prevailed both in judgments\textsuperscript{107} and academic writings\textsuperscript{108} in commonwealth countries over the last twenty years. But there are still two questions to reconsider, i.e. whether the duty of directors is owed directly or indirectly to the creditors, and, does future creditors exist and, if it does, should they be taken into account?

Lord Templeman states in \textit{Winkworth}\textsuperscript{109} that “a company owes its duty to its creditors, present and future …” in which he suggested a duty to future creditors exists. In \textit{Fullham Football Club Ltd v Cabra Estates plc}\textsuperscript{110} it was indicated that the directors should take the interests of potential creditors into account. But Dillon, L.J. said in \textit{Multinational Gas & Petrochemical Co. v National Gas & Petrochemical Services Ltd}\textsuperscript{111} that “ a company owes no duty of care to future creditors … so long as the company is solvent the shareholder are in substance of the company.”\textsuperscript{112}

\textsuperscript{105} Ibid
\textsuperscript{106} Percival v Wright [1902] 2 Ch 421
\textsuperscript{109} Winkworth v Edward Barton Development Co Ltd [1987] 1 All ER 114
\textsuperscript{110} [1994] 1 BCLC 363
\textsuperscript{111} [1983] 3 W.L.R. 492
\textsuperscript{112} Ibid, at 519
Meanwhile, Professor John Farrar criticised this idea by saying “they seemed to use the alter ego theory to lift the corporate veil in favor of creditors in a way which is unprecedented in Commonwealth case law”. Furthermore, it can be argued that future creditors could protect their own interests in deciding whether to do business with the company or not, a choice clearly denied to existing creditors. It can also be argued that it is indeed very difficult for the directors to look after the interests of the “future” or “potential” creditors because it would be a very hard job for them to identify and predict who will be “future” or “potential” creditors as the precondition of protecting their interests. Furthermore, this distinction is only appropriate where insolvent liquidation is not inevitable; once the company has reached that stage, there seemed little justification in differentiating between the two groups of creditors.

2.2.2 When does the duty begin?

A. The Company in an Insolvent Position

It has been argued that buying shares is very similar to participating in a lottery. This is because shareholders' losses are invariably normal, i.e. there are chances to gain and there are, meanwhile, chances to lose. Therefore, when the company is insolvent and the shareholder have nothing to lose, “the interests of company are in reality the interests of existing creditors alone” and the creditors then might be viewed as the actual owners of the company. It can be concluded that the directors owe duties to the owners of the company, namely creditors when the company is insolvent.

In a more recent Australian case Spies v The Queen, High Court's decisions have significant practical implication for company directors and insolvency practitioners.
and approve the comments that insolvency created a duty to creditors when the company is insolvent.\textsuperscript{119} Also in the frequently cited case \textit{Kinsela}\textsuperscript{120}, the Court of Appeal held the transaction in this case was voidable and found against the directors because of the clearly insolvent situation of the company when the lease was granted and farther proved the validity of directors’ duties to creditors when the company is insolvent.

Section 214 was introduced as a legislative response to the recommendations in the Cork Report in order to stop directors from continuing to trade while on the slide into insolvency and “regroup the loss to the company so as to benefit the creditors as a whole.”\textsuperscript{121} In this section, application for a petition by the liquidator against the past and present directors will take place when the company has entered insolvent liquidation\textsuperscript{122} or at the time of winding up when the company’s debts and liabilities, together with the expenses of winding up, exceeded its assets.\textsuperscript{123} The directors, subject to both objective and subjective tests,\textsuperscript{124} will only be liable if they knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation.\textsuperscript{125} Therefore, Section 214 established the legislative duties of the directors to look after the creditors’ interests when the company is in a state of insolvent.

But there are also ambiguous aspects in this section. For example, a director’s liability for wrongful trading will depend on whether he has taken every possible step with a view to minimise the potential loss to the company’s creditors as he ought to have taken.\textsuperscript{126} A director may also liable if he was knowingly a party to the carrying

\begin{footnotesize}
\begin{enumerate}
\item The comments were made earlier in \textit{Re New World Alliance Pty Ltd}, [1994] 51 FCR 425 at 444.
\item \textit{Kinsela v Russell Kinsela Pty Ltd} [1986] 4 ACLC 215
\item \textit{Re Purpoint Ltd} [1991] BCLC 491 at 499
\item Insolvent Act 1986 Section 214 (2) (a)
\item Insolvent Act 1986 Section 214 (6); this is also regarded as the “balance sheet insolvency”, more details in A. Keay, & P. Walton, \textit{Insolvency Law: Corporate and Personal}, Harlow: Pearson & Longman, (2003), see page 19; \textit{Byblos Bank SAL v Al-Khudhairy} [1986] 2 BBC 99, 549 (CA), \textit{Re A Debtor (No 17 of 1966)} [1967] Ch 590; [1967] 1 All ER 668; \textit{Re National Livestock Insurance Co} [1858] 26 Beav 155; 53 ER 855; This also excludes what maybe termed liquidity insolvency based upon a company’s liability to pay its debts on times.
\item Insolvent Act 1986 Section 214 (4)
\item The assessing whether there was no reasonable prospect of a company Professor S. Griffin argued in his book \textit{Personal Liability and Disqualification of Company Directors}, Oxford: Hart Publishing (1999) at 66 that “the following factors should be taken into account, namely: pressure from creditors owed debts, the withdrawal of support from banks, the loss of contracts, the fact that other contracts cannot be obtained, and the failure to pay Crown debts.”
\item Insolvency Act 1986, Section 214(3)
\end{enumerate}
\end{footnotesize}
on of any business of the company with intent to defraud creditors.\textsuperscript{127} But the
definition of “taking every possible step” and “potentials loss” is still awaiting more
detailed explanation from the legislators and judges.\textsuperscript{128} Furthermore, the section just
defined a single aspect of the company’s states namely insolvency which is none-
debatable as for the topic of this essay but perhaps this approach is only possible
because of the narrowness of the circumstances in which section 214 operate.\textsuperscript{129}

B. Near or in the Vicinity of Insolvency and Doubtful Solvent\textsuperscript{130}

As for the situation that the company relapses into the situation of near or in the
vicinity of insolvent, there are a few Australian and New Zealand cases confirm the
validity of the duty. For example, in the Australian High Court cases \textit{Re New World
Alliance Pty Ltd}\textsuperscript{131} and \textit{Spies v The Queen}\textsuperscript{132}, the court affirmed that the directors’
duties to creditors when the company is nearing insolvency; also in New Zealand
Cooke J. acknowledged in \textit{Nicholson v Permakraft Ltd}\textsuperscript{133} the validity of the duties of
the directors to creditors when the company is near insolvent, along with insolvency
or doubtful insolvent\textsuperscript{134}. Special importance is bestowed by Professor Andrew Keay
and Associate Professor Jonathan C Lipson\textsuperscript{135} in their articles\textsuperscript{136} on the United States
case of Delaware Court of \textit{Chancery NV v Pathe Communications Corp}\textsuperscript{137} in which
directors of a company "in the vicinity of insolvency" owed a duty to creditors “to

\textsuperscript{127} ibid, Section 213
\textsuperscript{128} There are more discussion about “Wrongful Trading” provisions in: A. Keay, ‘Another Way of Skinning
a Cat: Enforcing Directors’ Duties for the Benefit of Creditors’ (2004) 17(1) \textit{Insolvency Intelligence} 1;
of Law and Economics} 203; A. Hicks, ‘Advising on Wrongful Trading’ (1993) 14 \textit{Company Lawyer} 16
(Part 1) and 55 (Part 2)
\textsuperscript{129} C.A. Riley, ‘Directors’ Duties and the Interests of Creditors’ (1989) 10, \textit{The Company Lawyer} 87 at 90
\textsuperscript{130} This kind of situation is described by American Scholar as Credit Lyonnais
\textsuperscript{131} [1994] 122 ALR 531 at 550
\textsuperscript{132} [2000] 72 ALJR 1263
\textsuperscript{133} [1985] 3 ALCL 453
\textsuperscript{134} [1985] 3 ALCL 453 at 459
\textsuperscript{135} The decision of the case \textit{Chancery NV v Pathe Communications Corp} was described as the
landmark decision.
\textsuperscript{136} A. Keay, ‘The Director’s Duty to Take into Account the Interests of Company Creditors: Where is it
Cat: Enforcing Directors’ Duties for the Benefit of Creditors’, (2004) 17(1) \textit{Insolvency Intelligence} 1;
Lipson, J.C., ‘Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed
\textsuperscript{137} Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch.
LEXIS 215, (Del Ch. Dec.30 1991)
exercise judgment in an informed, good faith effort to maximize the corporation’s \(^{138}\) long-term wealth creating capacity.\(^{139}\) In this judgment the corporate enterprise comprises of both shareholders and creditors.\(^{140}\)

When it comes to the situation of the doubtful insolvency, the majority view of the Court of Appeal was expressed by Nourse L. J.\(^{141}\) in *Brady v Brady*:\(^{142}\)

“Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone.”\(^{143}\)

The similar idea is shared by other leading cases\(^{144}\) which confirm the directors’ duties to creditors when the company is in doubtful insolvency.

Although it is explicitly states in those cases the directors have a duty on creditor when the company is nearing insolvency or in doubtful insolvent. But it would be a very tough job to define what is “nearing insolvent” or “in the vicinity to insolvent” and “doubtful insolvent” while the conception of “insolvency” itself is still a debatable notion. The directors have to judge by using his own discretion when the company is in such situations which upgrade the directors’ duty\(^{145}\) and they also should “take stoke of the company’s position in order to ascertain whether the company will remain solvent after the action which is contemplated”\(^{146}\).

### C. The Company at risk of insolvency

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\(^{138}\) i.e. company

\(^{139}\) Ibid


\(^{141}\) Ibid, at 552

\(^{142}\) [1988] 3 BCC 533.

\(^{143}\) Ibid

\(^{144}\) Nicholson v Permakraft (NZ) Ltd [1985] 3 ACLC 453 at 459, 463, 464; *Re Hoursley & Weight Ltd* [1982] 1 Ch 442 at 455; *Geyer v Ingersoll Publications Co* 621 A 2d 784

\(^{145}\) The idea of upgrade the duty is express in: *Re D’ Jan of London Ltd* [1994] 1 BCLC 561(Hoffman LJ, then on the Court of Appeal, sat as a Chancery Division judge for the hearing), discussed by A. Hicks, "Directors’ Liability for Management Errors", (1994) 110 LQR 390

\(^{146}\) A. Keay, ‘Directors Taking into Account Creditors’ Interests’ (2003) *Company Lawyer* 300 at 303
In *Nicholson v Permakraft*\(^\text{147}\), Cook, J commented on situation which directors should consider creditors' interests including the situation when the director's "contemplated payment or other course of action could jeopardise its insolvency"\(^\text{148}\). That means if the directors' misfeasance put the company into risk of insolvency he will be personal liable to the creditors. But a very important point has to be made that if the directors are in good faith, the case has to be considered diversely. It will be a suggestive idea to assess the directors according to his or her knowledge and experiences in advance.

**D. The Company in a position of Financial Instability**

The directors maybe have to be responsible for the creditors’ interests when the company is in a dangerous financial position\(^\text{149}\) or financially unstable\(^\text{150}\). It is agreed that these blurry phrases basically means the company is in a bad condition that could very possibly result in insolvent. But this notion is still not practical enough for enforcement for directors. And how to differ it from ‘doubtful insolvency’ is another issue awaiting settlement.

**E. The Company which is very solvent**

When the company's assets are much more than its debt, it would be difficult to impose a duty on directors in relation to creditors, as there are no outstanding creditor claims the issues of breach of such a duty simply cannot arise.\(^\text{151}\) What is more is that the function of directors is to make judgments about business risks and to take those risks--- and to drive as hard a bargain as they can when negotiating with outside parties.\(^\text{152}\) If the directors are required to consider the interests of

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\(^{147}\) [1985] 3 ACLC 453
\(^{148}\) Ibid, at 459
\(^{149}\) *Facia Footwear Ltd (in administration) v Hinchcliffe* [1998] 1 BCLC 218
\(^{150}\) *Linton Telnet Pty Ltd* [1990] 30 ACSR 465 at 471
\(^{151}\) D.D. Prentice, 'Creditor's Interests and Director's Duties' OJLS (1990) 10, 265 at 276
\(^{152}\) This idea is supported by four leading cases, namely, *Re Halt Garage* (1964) Ltd [1982] 3 All ER; *Re Horsley & Weight Ltd* [1982] Ch 442, [1982] 3 All ER 1045; *the Multinational Gas and Petrochemical Co Ltd v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258, [1983] 2 All ER 563 and *Kuwait*
creditors even if the company is running smoothly it will make the directors in state of a constant-lasting panic and worry about the company too much and too early which will severely interfere his obligatory duties on shareholders.

The relationship among the companies’ interests, companies’ situations and directors’ duties in relation to creditors can be illustrated by the following diagram although not exactly precise in certain ways:

It would be very important for future researchers and judges to clarify the conception of the “insolvent”, “near insolvent”, “doubtful insolvent”, “risk of insolvent” and “financial instability” in order to make the extent of the duties clearer and easier to enforce. With the ascend of the risk, how directors can act\textsuperscript{153}, with their own discretion, to protect the creditors and does the court have the role to play are also pending questions awaiting more exact and reasonable judicial and academic explanations.

\textsuperscript{153} The legal obligations for the directors when the Company goes into financial trouble should be further discussed.
3.0 - CSR and Insolvency

3.1 The Directors’ General Role in Insolvency

From the foregoing analysis it must now be accepted that directors have responsibilities to creditors. But do directors owe a duty to any other stakeholders once they have been displaced as the controlling office holders in an insolvency procedure? Before we address that issue it might first be appropriate to define the directors’ role when their company is in a formal insolvency procedure. There are a number of instructive cases in this regard and some continuing statutory obligations. Directors have a number of obligations to perform, even when a company is in an insolvency procedure and, prima facie, controlled by someone else. For example, Kerr has opined that there still remains an obligation to: file accounts; file a directors report; to hold annual general meetings; to file annual returns; and, to lay copies of reports and accounts before an annual meeting. In Newhart Developments Ltd v. Co-operative Commercial Bank Ltd Shaw, LJ outlined the directors’ continuing role in receivership. He noted that the appointment of a receiver:

“Does not divest the directors of their company power, as the governing body of the company, of instituting proceedings in a situation where so doing does no in any way impinge prejudicially upon the position of the debenture holders by threatening or imperilling the assets which are subject to the charge.”

An Irish High Court decision, Lascomme Ltd t/a Ballyglass House Hotel v. United Dominions Trust (Ireland) Ltd and James Gilligan (Notice Party), also stands as authority for the proposition that directors powers are not displaced when an insolvency officeholder, namely an administrative receiver, is appointed.


157 Ibid.

Directors, it seems, do have some residual function even when their role has to some extent been usurped by an insolvency practitioner who has taken over day to day management of the company as part of an insolvency procedure.

3.2 Does Insolvency Displace Directors’ CSR functions?

If, pursuant to the forgoing analysis, it is accepted that directors owe duties, not least to creditors, in an insolvency context, can it be said that they should continue to also owe other species of duty, such as those in the nature of CSR? Or put another way, why shouldn’t directors continue to respect their CSR obligations even if a company is in an insolvency procedure? If filling accounts is still a requirement of directors when a company has entered an insolvency procedure, why shouldn’t ensuring CSR type obligations are met?

Some commentators may argue that CSR functions provide an unnecessary and costly burden on companies which should be the first cost to be stripped away, in favour of the essentials, when a company goes into an insolvency procedure. Others may argue that CSR is a proper and wholly valid function of the company and its management and that the management have as much a responsibility in this regard as they do in relation to the filling of accounts. Why should CSR become any less important just because a company has gone into an insolvency procedure? If the concept is to be completely grasped and wholeheartedly imbedded in must become as second nature as filling accounts.
Conclusion

In this paper it has been argued that directors owe duties to creditors, and indeed continue to owe duties to creditors, during formal insolvency procedures. Furthermore, it has been suggested that directors may also continue to have obligations towards wider stakeholders, including those that fall under the sobriquet of CSR. If our central proposition is correct, namely that directors do still have CSR obligations during formal insolvency procedures, then it could be argued that this continuing responsibility evidences how ingrained CSR concepts now are in English and Welsh law.