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Property developers personally liable

Insolvency and the single purpose vehicle

Developers should take note of a recent case in which an SPV's directors were held personally liable for its debts.

It's a common scenario (or it was, when developments could be funded…). Entrepreneurial developers identify an opportunity. They form a company to carry out the development – a single-purpose vehicle (SPV). They put in some "equity" – more often subordinated debt, or even a limited guarantee of bank debt – and often from a funding partner rather than the personal wealth of the developers. The rest of the money is non-recourse lending from the bank, secured on the property. All the equity goes on land purchase, so the build costs are funded entirely from bank money, advanced against certificates showing that valuable work has been done. There's a fixed-price building contract with the contractor – though how fixed may not always be clear to everyone.

If it goes well, the bank gets repaid on sale of the investment, or rolls its loan into investment funding. If sale price is greater than land cost plus development costs, the developers walk away with a profit. If it all goes wrong – cost overruns, long void period before sale or letting, fall in market prices – well, from the developers' viewpoint, they haven't lost much – the equity provider loses out, and the bank may take a bath, the contractor loses his retention and current unpaid costs, but the developers just go on to another project.

But what if the SPV liquidator cuts up rough? In Roberts v Frohlich and Another[1] the directors were found to have traded after there was no reasonable prospect of avoiding insolvency. They were made personally

[1] [2011] EWHC 257 (Ch), [2011] All ER (D) 211 (Feb)

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liable for the build costs after a certain date, on the grounds that this was a breach of duty to the company and wrongful trading[2].

They had juggled the contractor, the bank and a potential buyer of the development, keeping the balls in the air while trying to resolve some fundamental conflicts. The bank's conditions included a fixed price build contract and pre-sales, but the contractor was insisting on a cost-plus basis and no sales were likely until construction was under way. Neither bank not contractor knew that the other was not yet committed. In the meantime the directors got the contractor to do groundworks and civils under a letter of intent, and had the contractor order the steel for the construction, with no facility in place to pay for them. They drew down a bank facility for the preparatory works whilst knowing that they could not meet the conditions for the development facility. They continued to allow the contractor to run up large costs. They knew that the cashflows they and the bank had relied on could not be met. They were driven, in the words of the judge, by "*wilfully blind optimism; the reckless belief that… something might turn up.*" When the SPV went into administration and the property was sold, the bank got repaid, leaving the liquidator with a £25,000 fighting fund to pursue the directors on behalf of the unpaid contractor.

Norris J. found the directors guilty of three breaches of duty: (1) the fiduciary duty to the company to act in the interests of the company, which when the company is insolvent or of doubtful solvency or on the verge of insolvency becomes a duty to protect the interests of its creditors, (2) the fiduciary duty to act with reasonable care and skill and (3) the statutory duty[2] not to trade after there is no reasonable prospect of avoiding insolvent liquidation.

(3) is not surprising: directors can be made liable for debts they continue to run up after the point at which they should have called in an insolvency practitioner, and an order to that effect is likely in the next stage of the case. (1) and (2) are a little more surprising: the duty to the company to act in the interests of creditors has been well known, but it has never been clear what liability might attach to a breach. Unfortunately the reported judgment did not deal with remedies, so we are none the wiser.

What lessons can be learned? Directors cannot speculate wildly with other people's money, even if was willingly lent into a non-recourse vehicle like an SPV. Expect to see more "non-recourse" lenders to companies trying to recover losses through claims against directors.

Don't incur debts if you cannot be confident that funding will be in place to meet them. Be honest with bankers and suppliers – it is far too easy to slip from hard bargaining into deception. Or, as in this case, self-deception: make sure that the legal documents say what you wish they did.

Remember the shaving-mirror test: is today the day on which insolvent liquidation is inevitable?

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[2] Section 214 Insolvency Act 1986