***Charities and Directors’ Disqualification (Case note)***

Mrs Justice Falk has handed down her judgment in the Kids Company case following a long and sometimes acrimonious directors’ disqualification trial which lasted for ten weeks (*The Official Receiver v. Atkinson & Ors* [2021] EWHC 175 (Ch) – hereafter *Kids Company.* Reference to paragraphs refer to those in Falk J’s judgment). The charity collapsed into insolvent liquidation in 2015. A Charity Commission investigation has been on hold pending the resolution of the disqualification proceedings.

Over the course of a 221 page judgment Falk J carefully navigated through a jurisdiction which has been referred to as containing “murky waters of both law and…facts” (*Secretary of State for Trade and Industry v. Goldberg and another* [2003] EWHC 2843 (Ch), [2004] BCLC 597, para.6. Her Honour found that Camila Batmanghelidjh and Alan Yentob, together with six other directors, were not “unfit” pursuant to section 6 of the Company Directors Disqualification Act 1986 (CDDA86) in the way in which they ran Kids Company. As a consequence, the directors will not be disqualified from acting as company directors. This result is, pending any appeal by the Government, a vindication of the directors’ conduct in the management and insolvent collapse of the now defunct childrens’ charity.

The directors disqualification regime serves as a public protection mechanism as it removes unfit directors from being involved in the conduct of companies and encourages the “highest standards of business probity and confidence.” (*Cork Report*, Cmnd.8558, para.235). Once removed from office the directors can no longer harm companies and their stakeholders, including creditors. In the case of Kids Company, a charitable company, this includes the charity’s beneficiaries (known as “clients” at Kids Company).

The Kids Company case is another example of the Official Receiver pursuing high profile failures. They have limited resources so select the cases they bring very carefully. They tend to focus on high profile cases in order to send out a deterrent message to the public and directors of companies. Previous cases have included Farepak, and the ‘phoenix four’, former directors of MG Rover. The Official Receiver has also recently launched disqualification proceedings against the former directors of Carillion plc.

The Kids Company judgment raises questions about the conduct of the case by the Government’s Official Receiver. Was their approach too narrow in terms of director behaviour and the single allegation they decided to pursue in support of their arguments of unfitness? Or was the case misconceived from the outset because of the unique role of the director of a charitable company?

The procedural history

The Official Receiver’s central allegation was that the directors of Kids Company ran an “unsustainable business model” (para.52, 795). The Official Receiver argued that the directors ought to have known that failure was inevitable without immediate material change during late 2013 and 2014. Falk J held that the Official Receiver had not made out their case. It is unusual in directors’ disqualification cases for the Official Receiver to focus on one allegation. Normally, patterns of unfit behaviour are alleged which demonstrate unfitness. Failure to pay tax, failure to keep proper records and such like, when repeated, exhibit unfitness. In this case, the Official Receiver focused on one central allegation.

In the early stages of the disqualification trial the situation was looking hopeful for the defendant directors and Ms Batmanghelidjh. Falk J handed down an interim judgment (*Official Receiver v. Atkinson (Discontinued) & Ors* [2020] EWHC 2839 (Ch)) on the 22nd October 2020 that removed four major areas of potential complaint. These further areas that the Official Receiver wanted to raise were, (1) an alleged breach of the duty to promote the success of the company, which is an allegation of a breach of fiduciary duty, (2) an alleged breach of the duty to exercise independent judgment, (3) an alleged breach of the duty of skill and care, and finally, (4) an allegation that certain directors had made preferential payments to some creditors. These were additional allegations to the central allegation of “running an unsustainable business model.” In her October 2020 judgment Falk J ruled that these areas could not be raised on procedural fairness grounds, and so should be discontinued. The defendants had not been given enough notice of these allegations by the Official Receiver. Falk J could have permitted these allegations to have been put to the directors, but exercised the court’s discretion not to do so. This early set-back for the Official Receiver seems to have been portentous.

The reasoning on the main ground

The Official Receiver’s main case was that the directors had run “an unsustainable business model” and that they were therefore “unfit” under s.6 of the Company Directors Disqualification Act 1986. Ultimately this allegation proved to be too narrow. Despite evidence that the charity faced cash flow difficulties (para.244) and managers had over optimistic expectations about income (paras.282, 294, 642), which resulted in delays in payments to creditors, a lack of reserves, and failure to pay tax on time over the period of a decade, all factors which evidence a pattern of behaviour that might be evidence of “wrongful trading” (s.214 Insolvency Act 1986)), the Official Receiver failed to convince the judge that the directors were “unfit”. Somewhat alarmingly Falk, J noted towards the end of her judgment, “I have to confess that I do not feel much closer to a really clear understanding of the “single allegation” than I did at the start of the trial.” (para 796). This followed a ten week trial.

Falk J’s Kids Company judgment is noteworthy in a number of respects. The guidance in the case on the boundary between what a *de facto* director and Chief Executive Officer (CEO) will be very important for how charities are administered going forward. In the context of commercial companies, the relevant test was set out by the Court of Appeal in 1999 (*Re Kaytech International Plc* [1999] BCC 390). Falk J’s judgment is the first time the area has been discussed in the context of charities. The judge clearly states that these are two entirely different functions. CEOs will not want to push the boundaries of what the trustees do and what they as CEOs do. There can be no cross over or liability might arise. If the line is crossed then a CEO might be a *de facto* director and be liable in the same way that the Trustee directors could be. Camila Batmanghelidjh was held not to be a *de facto* director in the case because the judge found that the role she played included the functions of a CEO only. This is a very narrow distinction in practice and the judge justified her findings and different view from the evidence presented by the Official Receiver. Falk J held that there had been some appropriate delegation from the board and that on occasion Camila Batmanghelidjh did rub up against the boundaries of board responsibility and instructions, but ultimately she did not step over the line into trustee work. That is what the judge said the evidence showed. Charity CEOs will therefore want to stay within their specific functions and not cross over into the territory of Trustee responsibility.

The judgment certainly does not signal a new relaxed regulatory environment for charity trustees. The Insolvency Service still has the power to launch other “unfitness” cases against other charity trustees and may do so in the future where the charity is run through a charitable company, as opposed to a charitable trust. Future regulatory action is much more likely to come from the Charity Commission who can issue ‘official warnings’ to charities, or individual trustees. The negative publicity from this activity can be enormously damaging. In more serious cases the Charity Commission can launch inquiries and remove trustees. In the Kids Company case Falk J said that the Charity Commission was the best body to pursue regulatory action (para.910. See also para.522) and that the Insolvency Service had little experience in dealing with charities (paras.76 and 909).

As noted above, the Kids Company case also indicates that the proceedings mounted by the Official Receiver were inappropriately narrow, and that there were other problems with the conduct of the case (para.72). Trustees should still pay very close attention to their statutory duties and keep a close eye on liquidity issues. In the future, other charities could face more than just that one allegation as for non-charitable company directors have across many, many unfitness cases. For example, failure to pay tax, such as PAYE, is one allegation that directors have faced, including in the seminal Court of Appeal authority which stipulates the time periods of disqualification (Dillon, LJ in *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164. See also *Re Dawson Print Group Limited* [1987] BCLC 601 and *Re McNulty’s Interchange Limited* [1989] BCLC 709). Failure to pay PAYE also arose at Kids Company in 2002 but the £600,000 tax debt was, perhaps unusually, written off by the Government (para.48).

The Kids Company case raises some interesting points around benevolent treatment of charitable companies, to ensure consistency with charitable trusts, as compared with for profit companies. Falk J discusses this policy approach of the courts from para.848. The judge relies on, amongst other authorities, Lady Arden in *Lëhtimaki* (see: John Picton, *Lëhtimaki v Cooper: Duty and Jurisdiction in Charity Law*, (2021) MLR, vol. 84, issue 2, March, pp.383-393). For Falk J a benevolent approach by the court is appropriate to ensure parity between charitable companies and trusts. It could be argued that there should be parity of behaviour between office holders of both legal fictions, i.e. between the idea that a charitable trust can also have people accounted trustees even if they are not validly appointed. In other words if a person is not a *de facto* director of a charitable trust, is she a trustee de son tort of a trust? The law of trusts has developed the area of trustees *de son tort* (see: *Williams v. Central Bank of Nigeria* [2014] UKSC 10) to deal with people influencing the operation of the trust.

Falk J’s judgment also raises interesting questions around tax. Her Majesty’s Revenue and Customs (HMRC) have traditionally been given dominance due to their role as an involuntary creditor. HMRC is usually persistent in chasing tax liabilities. Completely at odds to this usual stance at para.334 Falk J refers to their “patient” behaviour in the case, particularly around delays in payment of tax liabilities in 2013 and 2014 (discussed in para.214 and 244). But it is a 2002 PAYE tax liability that is most interesting in the context of directors’ disqualification and different treatment for different types of company (charitable/for profit). Kids Company had a £600,000 reprieve from Dawn Primorolo in 2002 (para.48 – Primorolo was Paymaster General at the time). This seems to be another example of different treatment for commercial and charitable companies, not just by the courts with Falk J’s benevolent approach, but also HMRC. Commercial companies would not normally be afforded this kind of tax relief. Indeed, directors have been disqualified previously when the companies they controlled owed much less tax than £600,000, including in 2002 (see: *Frewen v. Secretary of State for Trade and Industry* [2002] EWHC 2688 (Ch) where Park, J affirmed a two year disqualification order that Registrar Baister had made for, amongst other things, non-payment of PAYE).

Another area of note is on the question of record keeping, particularly minutes of company meetings. Previously directors have been disqualified for failing to keep proper books and accounts (e.g. *Re Rolus Properties Limited* (1988) 4 BCC 446 and *Re Western Welsh International System Buildings Limited* (1988) 4 BCC 449). Not keeping proper accounts or books and not paying tax are key Schedule 1 CDDA86 areas that show a pattern of behaviour suggestive of unfitness. Statements of Insolvency Practice (SIPs) 2 and 4 also contain guidance to this effect. SIP 2 sets out the matters that are to be investigated by the IP. SIP 4 sets out the reporting process for IPs, as opposed to Official Receiver reports. The contents of these reports are to some extent dominated by identifying personal gain. It is unusual that the level of salary in the Kids Company case was not considered (£90,000 for the CEO see para.19). HMRC usually restrict the level of directors’ salaries in Company Voluntary Arrangement (CVA) proposals. As noted above, Schedule 1 to the CDDA86 lists matters that the courts should have regard to when considering a disqualification case. However, those matters are not exhaustive. SIP 2 stipulates that IPs should also include other matters that they believe to be relevant as the Disqualification Unit of the Insolvency Service attaches particular importance to other matters. In the context of the Kids Company case these include “use of delaying tactics” and “non-payment of Crown debts to finance trading”. Whether or not a director has engaged in a course or pattern of unfit conduct is also important. Examples of this may include failure to keep minutes, or failure to pay tax on time. Inadequate record keeping has led to a disqualification order of 8 years. This avenue is pursued particularly when the director has a history of poor record keeping in an earlier liquidation and that allegation had not been pursued. Falk J’s judgment shows there was inadequate record keeping, yet the Official Receiver did not bring allegations of this type (para.276, 277, and 279. See also para.653 on editorial control of minutes and their brevity).

Finally, the judgment raises interesting questions around charity rescue. As Falk J observes in her judgment (para.602 onwards) the charity may have survived if the unfounded sexual assault allegations had not undermined the 2015 survival period restructuring plan. This would have meant the valuable public benefit purposes Kids Company was performing would have continued. This raises the question of charities and the rescue culture in English and Welsh insolvency law. Kids Company may have been rescued two years earlier than the sexual assault allegations and the eventual liquidation. Falk J notes that in 2012 the directors of Kids Company shied away from using an insolvency process (para.272). This fear of insolvency processes has long been an issue in English law (*Corporate rescue: CVAs and the challenge of small companies* (Milman and Chittenden,. 1995)) and it seems a change in director mindset is still needed if the rescue procedures are to be properly utilised. If the rescue procedures such as administration and company voluntary arrangements (CVAs) are grasped at an early stage then more rescues will flow, diminishing the number of wrecks which Chamberlain drew attention to as early as 1883 (Hansard). In the context of charities this means that more public benefit will flow from the salvaged charities. This approach to the rescue of charities, to maintain charitable purposes, has been discussed elsewhere (Tribe, J. P. (2020). *Deploying Communitarianism Bankruptcy Theory to Rescue Insolvent Charities and Maintain Charitable Purposes*. In J. Picton, & J. Sigafoos (Eds.), *Debates in Charity Law* (pp. 81-101). Oxford: Hart Publishing.). If the directors of Kids Company had engaged in a rescue procedure earlier they may have avoided the liquidity problems that eventually led to the insolvent liquidation in 2015.

**Conclusion**

There are a number of lessons that can be drawn from the decision. Trustees will want to guard against allegations of “doing too little too late.” To avoid this, controlling expenditure and cutting costs in periods of illiquidity seem key. Those who control charities should not be overly optimistic regarding financial difficulties and should properly consider the risk of donor fatigue (on optimism and future trading see: *Re Produce Marketing Consortium Ltd (No.2)* [1989] BCLC 520). Reliance on short term loans and delaying payments to creditors are also problematic.

The Kids Company result is problematic for the Official Receiver as it sends out the messages which could discourage directors from accepting directors’ disqualification undertakings (DDUs). Sunetra Atkinson agreed to accept a directors disqualification undertaking for a period of two and a half years. She had been a director of Kids Company for nine years. This undertaking route is based on the historic use of *CareCraft* Orders (see Ferris, J in *Re Carecraft Construction Co Ltd* [1994] 1 WLR 17) now placed on a statutory basis. Undertakings are cheaper for both sides as they avoid the need for a court hearing.

The case failed because one allegation was brought by the Official Receiver and it was not proved to the judge’s satisfaction. The outcome of the case says more about the framing of the allegation than any overarching policy difference in the application of the disqualification regime as it applies to charitable company directors. Further, the outcome of the case may encourage more directors to refuse an undertaking when they can see the benefit of challenging the allegations. This could allow those who are validly appointed directors to pass responsibility and place blame on those they have delegated authority to.

High standards are still part of the relevant statutes that regulate companies, including charitable companies. This is particularly important to remember as a number of charities have been shown by the Charity Commission to have governance problems.

John Tribe

University of Liverpool