inbrief

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Insolvency - issues for directors

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Introduction

All directors owe duties to their companies. When a company is solvent, those duties are owed to the company personified by its shareholders. But when insolvency is pending, directors must act in the company's creditors' best interests. That difference means that the nature of the directors' duties undergoes a significant shift when insolvency threatens.

Who is a director?

The Companies Act 2006 describes a director as including any person occupying the position of director by whatever name called. A person registered at Companies House as a director will be a director. Someone who is acting as a director without having been validly appointed will also, generally, be a director. Directors include executive and non-executive directors and anyone in accordance with whose directions or instructions the directors of a company are accustomed to act (a shadow director). It is a person's function rather than his or her title that is important.

Someone closely involved in the management and direction of the company, even if employed as a consultant or through a service company, may be deemed to be a director for all purposes relating to insolvency.

When is a company insolvent?

The point at which a company is insolvent is fundamental to directors' decision making, as it is from that point on that directors may become personally liable for debts incurred by the company. Therefore, directors must be able to recognise when to stop trading and to take every step to minimise losses to creditors.

- The two most generally accepted tests of insolvency are:
- Balance sheet test (where the value of a company's assets are less than its liabilities, taking into account contingent and prospective liabilities).
- Cash flow test (where it is proven that a company is unable to pay its debts as they fall due. This is deemed to be so where a company fails to comply with a statutory demand for a debt exceeding £750, or a judgment debt remains unsatisfied).

Areas of potential liability

Generally, directors are not responsible for a company's debts - other than when they have agreed to be liable, for example, by giving a personal guarantee in support of a loan to the company. Three statutory exceptions to this general rule are where a court makes findings of wrongful trading, fraudulent trading or misfeasance against a director. A further possibility is where a director is found liable for the tort of deceit.

Wrongful trading[1]

1st March 2020 update:

In the light of COVID-19, the Government has announced the suspension of wrongful trading provisions. This measure is aimed at avoiding premature insolvencies of otherwise financially viable companies by allowing directors to continue their businesses without threat of personal liability should the company ultimately fall into insolvency. The suspension will take effect retrospectively from 1 March 2020 for a period of three months, with a possible extension if deemed necessary. The suspension will apply to all companies, not just those directly affected by COVID-19 related issues.

Where wrongful trading provisions would usually encourage directors of companies facing financial difficulties to restrain borrowing and reduce liabilities (for example, in the number of staff they employ), the suspension acts as recognition that directors are facing unprecedented difficulties in assessing the ongoing financial viability of companies through such uncertain times and directors should not be penalised for doing all they can to rescue their companies.

It is important to note that only wrongful trading provisions have been suspended and all other legislation deterring director misconduct remains in place. Directors still therefore need to be very careful to not expose themselves whilst navigating the current challenging economic environment.

In view of this suspension, the parts of our note below regarding Wrongful Trading do not currently apply. However, all other parts of the note apply as usual for now.

Suspended Provisions as of 1st March 2020:

Wrongful trading occurs if a company has gone into insolvent liquidation or administration, and before the commencement of the winding up or administration, a person who is or has been a director, knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or administration but the company continued to trade and incur credit.

1. This InBrief was updated on 2 April 2020 and reflects our understanding at this time.

Following a declaration of wrongful trading a director may incur personal liability for debts incurred by the company after the point he knew or ought to have concluded there was no reasonable prospect of avoiding insolvent liquidation or administration.

Being found liable under these provisions may also lead to disqualification from acting as a director.

Fraudulent trading

Fraudulent trading occurs if a company has gone into insolvent liquidation or administration, and, on application of the liquidator or administrator, it is found that the business of the company has been carried on with the intent of defrauding creditors, or for any fraudulent purpose. The potential scope is wide: a liquidator or administrator can apply to court for a contribution from any persons who were knowingly parties to the carrying on of a business in such a manner. Fraudulent trading is also a criminal offence. Again it may lead to disqualification from acting as a director.

Misfeasance

If, in the course of a winding up, it appears that a director has misapplied or retained, or become accountable, for any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty, the court may order the director to repay, restore or account for money or property with interest or contribute to the company's assets by way of compensation. This section of the Insolvency Act also applies to any officer of the company and any person who has been concerned, or has taken part, in the promotion, formation or management of the company.

The application for this remedy may be made to the court by the Official Receiver or liquidator or any creditor or contributory and the court can make such order as it thinks fits.

Directors disqualification

A disqualification order may be made against a person who is or has been a director of an insolvent company where that person's conduct as a director of that company makes him unfit to be concerned in the management of a company.

A disqualification order will last for a minimum of two and a maximum of fifteen years. The Registrar of Companies maintains a publicly available list of disqualified directors.

In determining conduct that has rendered a person unfit to be a director, the court will have regard to several matters including any breach of duty by the director in relation to the company, any misapplication or retention of the company's money or property, or the conduct of the director in relation to an insolvent overseas company. In addition, the court will assess the extent of the individual director's responsibility for:

- The causes of the insolvency
- Any failure by the company to supply goods or services which have been paid for
- The entering into by the company of any transactions being a preference or at an undervalue.

A liquidator of a company has a positive duty to investigate the affairs and causes of failure of the company and conduct of directors who were in office for the last three years of trading. The liquidator has extensive powers to require information and documentation and is required to report unfit directors' conduct to the Secretary of State to decide whether to bring disqualification proceedings. The Secretary of State for Business, Innovation & Skills will take action if a director's behaviour has fallen below the appropriate standard.

Transactions at an undervalue and preferences

An administrator or liquidator of an insolvent company, can challenge certain pre-insolvency transactions including preferences and transactions at an undervalue. A transaction at an undervalue is a transaction which took place up to two years prior to the onset of insolvency, where the disposition was a gift or the value received by the company was significantly less than the value of the assets sold and the company was either unable to pay its debts at the time of the transaction or was made unable to pay its debts as a result of the transaction. If the transaction is with a connected person, (e.g. with a director or a company with common directorships or shareholdings), a court will presume that a company was insolvent or was made insolvent by the transaction.

A company gives a preference if in the period of six months prior to the onset of insolvency (or two years if the transaction was with a connected person) it does something which has the effect of putting a creditor or a surety or a guarantor in a better position in the event of the company's winding up than they would otherwise have been in. In deciding whether a preference has been given, a court must be satisfied that the company was influenced by a desire to produce that outcome. In the case of a person connected to the company the desire to prefer is presumed. An example of a preference would be if a company were to discharge a bank loan which it was personally guaranteed by a director.

If a court decides that a transaction was at an undervalue or was a preference it can, in certain circumstances, set the transaction aside or make other orders to remedy the wrong done or loss caused, including demanding financial restitution from the company's directors.

Deceit

A director may also be personally liable for damages where he or she signs a document which represents that a company has capacity to meet its obligations in circumstances where he or she knows that it does not. Although the underlying statute dates back to 1828, the courts have demonstrated a willingness to apply it in an insolvency context against directors.

The representation may be made impliedly rather than expressly. For example, the Court of Appeal upheld a judgment against a director who had signed a document containing a promise (by the company) to pay for goods to be ordered in the future. The court held that the promise included an implied representation as to the company's capacity to make payment.

Practical steps

There are steps that directors can take to minimise exposure to personal liability upon the occurrence of corporate insolvency. Overall, directors must take every step possible to minimise potential losses to creditors, remembering that there is no general defence that having regard to all the circumstances, a director acted "honestly and reasonably".

Do's

- If you propose to carry on trading, be certain that there is a reasonable prospect that all debts can be paid as they fall due.
- Be proactive - regularly monitor the company's finances and management accounts. Ensure that they are up to date so that a proper assessment of the company's financial status can be made.
- Comply with financial covenants and monitor loan facilities. If the company misses a repayment, the entire amount of a loan might become repayable - a sum which the company may not be able to meet.
- Communicate with other directors. Concerns as to the solvency of the company should be raised and reviewed at board level. If, when legitimate concerns are raised by one director, the others refuse to act, that director may contemplate resigning to highlight his concerns but the full reasoning behind that resignation should be properly minuted/recorded in writing.
- Hold regular board meetings and keep proper records of board reasoning and decisions. If the board considers whether the company should continue trading, minute this carefully.
- Take advice if the company is considering entering into a contract with a connected person or where the value accruing to the company seems low, or where one creditor is being paid off in preference to others.
- Seek professional advice from an insolvency practitioner, appropriate lawyer or accountant.
- If in place, check the terms of directors' and officers' insurance policies for cover for liabilities related to insolvency. If not, consider taking D&O insurance. It is designed to protect directors against claims made in respect of discharge of their duties.

Don'ts

- Wait for the service of proceedings for failure to pay a debt to be alerted to problems.
- Incur further credit that cannot be repaid.
- Resign immediately at the first sign of trouble. Resignation is unlikely to constitute taking every step to minimise losses to creditors. Actions of past directors will be scrutinised if the company becomes insolvent later.
- Declare a dividend if there are concerns about solvency.
- Divert business away from the company without taking advice.
- Try to rescue the insolvent venture through a purchase of the business by a company in which you are involved without taking advice. If the companies trade under the same name, involvement by you in both can lead to personal liability for the old company's debts and may be a criminal offence.

Assignment of rights of action

As a general point, an administrator or liquidator of an insolvent company can assign the company's claims or causes of action to a creditor or other third party (subject to any contractual provisions which may prohibit assignment). This might be attractive where there are insufficient funds to pursue it on behalf of the estate or due to the factual complexity or time involved in pursuing litigation. The terms of assignment might be absolute in return for a one-off payment. Alternatively, the office holder might agree to take a share in proceeds arising.

Since 1 October 2015, rights to assign have been extended to include those type of claims which were previously exclusive to the office holder, arising only upon their appointment. These include fraudulent trading, wrongful trading, transactions at an undervalue, and preference claims.

Once assigned, the creditor or third party takes the claim forward. This may be significant because claims could be assigned, for example, to shareholders, creditors or employees of the insolvent company, any of whom may have more resources and/or appetite to pursue claims in satisfaction of sums they have lost in the insolvency.

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