Duties of the directors of companies in financial difficulties

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Contents

1. Introduction 01
2. Overview 01
3. Practical guidance 02
4. Common law, statutory and regulatory duties 02
5. Disqualification 05
6. Vulnerable transactions 05
7. Groups 06
8. EC Regulation on Insolvency Proceedings 07
Duties of the directors of companies in financial difficulties

1. INTRODUCTION

1.1 This memorandum considers the duties and responsibilities of directors of public and private companies under English law where a company is in financial difficulties.

2. OVERVIEW

2.1 Whilst a company is trading solvency, the duties of the directors are owed to the company for the benefit of present and future shareholders. It is assumed that, in making profits for the benefit of the company and its shareholders, there will be sufficient funds generated or available to the company to meet all liabilities to creditors as they fall due. However, once the company becomes insolvent or there is doubt as to its solvency the directors must also act in the interests of the company’s creditors in order to minimise the potential loss to them.

2.2 The duties of the directors in this situation can be split into common law, statutory and regulatory. A breach of these duties can lead to personal liability and possible disqualification from being able to act as a director or being involved in the management of the company for a specified period.

2.3 The duties summarised in this note will normally arise when the company is in financial difficulties, based on a cash flow or balance sheet test. Cash flow problems can arise if there are insufficient funds being received by the company to meet its liabilities as they fall due. This will be a concern if there is an immediate cash flow shortage with liabilities not being met, or it may be an issue which is expected to arise at some stage in the future. It is not acceptable to wait until cash stops flowing into the company. The issues have to be addressed as soon as the directors realise a cash flow shortage is likely to arise.

2.4 The balance sheet test arises if at any time the directors are aware that, on a book or market valuation basis, the accounts of the company show that its liabilities (including contingent and prospective liabilities) exceed its assets. It is generally accepted that this test should be applied to accounts prepared on a going concern basis, as it is likely that many companies would be balance sheet insolvent if the accounts were prepared on a break-up basis. Insolvency on a balance sheet basis does not generally mean that the company should immediately stop trading but provides a clear indication to the directors that there are difficulties and there would be no doubt that if the company did stop trading and the business were not sold profitably, its liabilities would not be met and creditors would therefore suffer loss.

2.5 Problems may manifest themselves before a cash flow or balance sheet test issue arises if, for instance, the company is in breach of a borrowing or other covenant in its loan or other documentation with creditors. Breach of these covenants will be an indication that the company may be in difficulties and at that stage a creditor, probably its bank, will want to be able to enforce
its rights or, more likely, to discuss with the company how the situation can be remedied.

3. PRACTICAL GUIDANCE

3.1 As soon as the directors become aware of any of the above difficulties they should seek professional advice, principally from the company’s lawyers and possibly also from a licensed insolvency practitioner at one of the large accountancy firms. As a starting point, the directors can seek advice from the firm of accountants which is the company’s auditor (assuming that firm has no conflict of interest in advising in this dual capacity). Depending on the circumstances, the company may also need advice from an investment bank.

3.2 In order to assess the extent of the problem, the directors will, at the very least, need an up-to-date cash flow statement, whatever recent monthly or other management accounts are available and appropriate projections, such as of trading prospects, cash flow and financial covenant compliance. In addition, the company and its lawyers should conduct a review of the events of default and covenants in the company’s loan and other relevant documentation. Any actual or potential breaches should be brought to the immediate attention of the directors.

3.3 The full board of directors should meet as soon as possible after the preliminary assessment of the position. If any of the directors cannot attend in person, they should do so by telephone. The meeting should consider the circumstances which gave rise to the difficulties and the company’s financial condition. The company’s lawyers should advise the board of the statutory and other duties of the directors in this situation, both in general terms and by application to the facts. If an insolvency practitioner or investment banker has been appointed, his views should also be given to the board. The directors will then need to consider the alternatives open to them, bearing in mind the interests of creditors if the situation so demands. Decisions then need to be made as to what the company should do in the light of the circumstances and the professional advice.

3.4 A detailed board minute should be prepared and approved at a subsequent board meeting. Further board meetings should be held to continue to review the situation: these may need to be held frequently if the situation is fast moving. The company’s advisers should be present at these meetings. A full paper trail is important to show that the directors have assessed the situation properly, taken appropriate advice on a regular basis and, insofar as they considered it appropriate, acted in accordance with such advice in order to fulfil their duties to the company and, as necessary, its creditors.

4. COMMON LAW, STATUTORY AND REGULATORY DUTIES

4.1 The common law duty of a director when a company is insolvent or of doubtful solvency is to act in the interests of creditors, with a view to minimising the loss to the creditors of the company from time to time. This position has been preserved by the Companies Act 2006, which codified the general duties of directors and made them subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

4.2 Under Section 212 of the Insolvency Act 1986 if, in the course of a winding up, anyone who has been involved with the promotion, formation or management of the company is found to have misapplied, retained or become accountable for
any money or other property of the company, or been guilty of misfeasance or breach of a fiduciary or other duty in relation to the company, a court may on an application by the official receiver, liquidator or a creditor compel him to:

(a) repay, restore or account for the money or property of the company with interest; or

(b) contribute such sum to the company’s assets by way of compensation in respect of the misfeasance or breach of fiduciary duty or other duty as the court thinks just.

Breaches of duty which could be relevant here would include a director’s involvement in the company granting a preference or entering into a transaction at an undervalue (which are explained below).

4.3 Personal liability attaching to the director can also arise following an application to the court by a liquidator for fraudulent trading (section 213 of the Insolvency Act 1986). The court can order that any person who was knowingly a party to carrying on the business of the company with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, is liable to make such contributions to the company’s assets as the court thinks proper. Fraudulent trading is also a criminal offence carrying with it the risk of imprisonment, a fine or both. Such an offence may apply whether or not the company has been, or is in the course of being, wound up.

4.4 Fraudulent trading can arise when directors of a company allow it to incur debt when they know there is no good reason for thinking that funds will be available to repay the amount owed when it becomes due or shortly thereafter. Thus directors have to be satisfied that services or goods supplied to the company can be paid for on the relevant due date.

4.5 Wrongful trading (section 214 of the Insolvency Act 1986) can lead to personal liability, although there have been few reported cases. It applies where a company has gone into insolvent liquidation and:

(i) before the commencement of the winding up, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and

(ii) thereafter the director failed to take every step with a view to minimising the potential loss to the company’s creditors which he ought to have taken.

In such cases, the liquidator can apply to the court for an order that the directors shall be liable to make such contributions to the company’s assets as the court might consider proper.

4.6 The standard required as to what a director ought to know, the conclusions he ought to reach and steps he ought to take is that which would be known, reached or taken by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as those of the director in relation to the company and with the general knowledge, skill and experience that the director has. Thus there is both an objective and a subjective test.

4.7 Under the Banking Act 2009, giving notice to the Financial Services Authority of the presentation of a petition for the winding up of a bank or an application to place it into administration, if done with a view to minimising the potential loss to a
bank’s creditors, may assist a director of a bank to defend a wrongful trading claim.

4.8 Not only do the wrongful trading provisions apply to directors or former directors (and there is no distinction in principle for these purposes between executive and non-executive directors), they also apply to shadow directors and de facto directors. A shadow director is a person or company in accordance with whose instructions or directions the directors of a company are accustomed to act. A de facto director is a person occupying the position of director, regardless of the title he goes by, who has not been formally appointed as a director.

4.9 Directors of a public company have a duty under Section 656 of the Companies Act 2006 to convene a meeting of shareholders in certain circumstances if there is a serious loss of capital. The section provides that where the net assets of a public company are half or less than its called up share capital, the directors must, not later than 28 days from the earliest day on which that fact is known to a director, convene a general meeting of the company for a date not later than 56 days from that day for the purpose of considering what, if any, steps should be taken to deal with the situation. A breach of these requirements can lead to the directors being liable to a fine.

4.10 There may also be a requirement under the UK Listing Authority’s Disclosure and Transparency Rules (“DTR”) for an announcement to be made. DTR 2 requires a listed company to notify a Regulatory Information Service (“RIS”) (i.e. make an announcement) as soon as possible of any inside information which directly concerns that company. ‘Inside information’ is defined in Section 118C of the Financial Services and Markets Act 2000 (“FSMA”) as, broadly, information of a precise nature relating (directly or indirectly) to a company or its listed securities, which is not generally available and would, if generally available, be likely to have a significant effect on the price of the company’s listed securities or on the price of related investments (e.g. derivatives linked to the company’s shares). Information is likely to have a significant effect on price if, and only if, it is of a kind which a reasonable investor would be likely to use as part of the basis for his investment decisions. Likely relevant information includes information which affects the assets and liabilities of the company, the financial condition of the company and the performance, or expectation of the performance, of the company’s business. Listed companies have a separate, but related, obligation under LR 7.2.1R of the UK Listing Authority’s Listing Rules to communicate information to holders and potential holders of their listed equity shares in such a way as to avoid the creation or continuation of a false market in such shares.

4.11 Any breach of the requirements of DTR 2 or LR 7.2.1R could lead to potential censure, fines or compensation orders made by the Financial Services Authority under Sections 91 or 382 of FSMA. As a separate matter, a failure to make an announcement may also result in the listed company or its personnel committing a criminal offence under Section 397 of FSMA, or committing the civil offence of market abuse under Section 118 of FSMA (and in particular Section 118(8)). In relation to the latter provisions, the particular issue of concern which can arise if no announcement of financial difficulties is made is that there could be a false market in the trading of the company’s securities. The securities may be trading on the basis of the latest financial report or announcement issued by the company which indicates or implies that its business is, say, reasonably profitable, whereas the directors may know that there have been breaches of covenants or other difficulties and that negotiations with the banks are underway. Without an additional
announcement, dealings may take place on the basis of the earlier financial report or announcement which leads investors to attribute a false (higher) value to the securities.

5. DISQUALIFICATION

5.1 Apart from the risk of incurring personal liability, where a director engages in fraudulent or wrongful trading or has been found guilty of other misconduct in connection with a company and is held to be unfit by the court, he may also be disqualified by court order or have a disqualification undertaking accepted by the Department for Business, Innovation and Skills under the Company Directors Disqualification Act 1986 (“CDDA 86”). The relevant provisions of the CDDA 86 may now also apply to directors of banks that have been placed into liquidation or administration under the Banking Act 2009.

5.2 A director may be prevented from acting as a director or from having any involvement in the promotion, formation or management of a company for a period of between two and fifteen years.

5.3 The court will examine a number of factors in deciding whether a person is unfit to be a director or to be involved in the management of a company. These will include not only breach of duty or responsibility for the insolvency but also issues such as late filing of accounts and other documents at Companies House. It is advisable to ensure that the company’s filing and internal records are up to date.

6. VULNERABLE TRANSACTIONS

6.1 In addition to the above issues, directors should be aware that if the company enters into certain types of transaction within specified periods before its insolvency, an administrator or liquidator may be able to apply to the court for an order that the parties be put back into the position they would have been in if the transaction had not been entered into, or require some other appropriate remedy. With regard to certain of these matters, entering into such a transaction could be treated as a breach of duty by the directors, in particular if the transaction is at an undervalue or is a preference.

6.2 A transaction is at an undervalue (section 238 of the Insolvency Act 1986) if a company makes a gift to a person or enters into a transaction on terms where the company receives no consideration or one which has a value which, in money or money’s worth, is significantly less than the value, in money or money’s worth, of the consideration provided by the company. There is a defence that the transaction is entered into in good faith for the purpose of carrying on the company’s business and that there are reasonable grounds for believing that it will benefit the company.

6.3 To be vulnerable, a transaction at an undervalue must have been entered into during the period of two years before the commencement of winding up or administration and the company must have been insolvent on a cash flow or balance sheet test at the time it entered into the transaction or become insolvent as a result of entering into it. There is a presumption of insolvency if the parties to the transaction are connected, for instance if it is an intra-group transaction or a transaction with a director.

6.4 The same undervalue definition applies in respect of transactions defrauding creditors (section 423 of the Insolvency Act 1986), although there is no time limit between the transaction being effected and the onset of insolvency for the transaction to be challenged. However, the transaction must
have been entered into for the purpose of putting the assets beyond the reach of the claimant or of otherwise prejudicing the interests of the claimant.

6.5 A preference (section 239 of the Insolvency Act 1986) is given to a creditor or a guarantor or a surety of the company's debts if the company does anything or suffers anything to be done which has the effect of putting that person in a position which, if the company were to go into insolvent liquidation, would be better than the position he would have been in if the thing had not been done. The repayment of an unsecured debt by a customer to its bank could fall within this wide definition. The company must have been influenced in deciding to give the preference by a desire to produce the preferential effect, in order for the transaction to be vulnerable. There is a presumption that the company was influenced by such a desire if the transaction was with a connected person.

6.6 Any such transaction will be set aside if, in the case of a non-connected person, it was entered into within six months of either the commencement of the winding up of the company or its entry into administration. This period extends to two years in the case of a connected person. The company must have been insolvent at the time it entered the transaction or become insolvent as a result of entering into it.

6.7 If a transaction is established as being at an undervalue or a preference, the court has very wide powers to put the parties back into the position they were in before the transaction was entered into, although there is protection for a third party who enters into such a transaction in good faith and without notice.

6.8 A floating charge may be invalid (section 245 of the Insolvency Act 1986) if it is created within two years of either the commencement of the winding up of a company or its entry into administration, if the parties are connected, or one year if they are not. There is a defence that the company was solvent when the charge was created (on a balance sheet and cash flow test) and did not become insolvent as a consequence of the transaction, but this solvency test will not apply if the parties are connected.

6.9 The charge will, however, be valid to the extent of the value of so much of the consideration for the charge as consists of money paid or goods or services supplied to the company at the same time as or after the creation of the charge, together with interest, if any, payable under the relevant agreement.

7. GROUPS

7.1 It must be borne in mind that where the company in financial difficulties is part of a group, the structure needs to be considered and similar issues addressed in respect of each company. If, for instance, a subsidiary is relying on its parent's support for finance and the parent is in financial difficulties, the directors of the subsidiary should meet to decide whether it is appropriate for it to continue to carry on its business, or whether alternative finance is available. In cases where a subsidiary has guaranteed the parent's bank borrowing, the directors will need to consider the implications of an increase in the subsidiary's liabilities if a call is made under the guarantee.

7.2 Issues of conflict must be considered if directors of the parent are also directors of a subsidiary. Different interests and duties will be owed by directors of different companies to each of those companies, and they will have to address how to handle information received as a director of one company when considering issues in respect of another company.
7.3 Some companies in the group may be situated overseas and consideration will need to be given as to the advice required by those companies in respect of their liabilities, and the duties of their directors in respect of them. As a general rule, certain countries are more debtor friendly and debtor driven, in particular the US, whilst other countries, including England, are subject to a more creditor driven regime.

8. EC REGULATION ON INSOLVENCY PROCEEDINGS

8.1 Where an English company in financial difficulties has its main business interests in, or has been administered from, another EU country it is possible that the court in that country may decide that the company’s “centre of main interests” is located in its jurisdiction and allow main insolvency proceedings to commence in that country. To the extent that the insolvency law of that jurisdiction provides for penalties or proceedings against directors for breach of duty, the English company’s directors may be subject to the law of that country. Advice should be sought on whether the law of another country may apply to the duties of the directors and whether local legal advice is required.