DUTIES OF DIRECTORS IN RELATION TO COMPANIES FACING FINANCIAL DIFFICULTIES

This note summarises the current duties of directors of a company and the potential for them to incur personal liability in that capacity, where that company is facing financial difficulties. It also recommends practical steps that directors can take to ensure that they fulfil their duties as a director of the company and to protect themselves against potential personal liability.

YOUR DUTIES AS A DIRECTOR

In the ordinary course, directors are under a duty to act in the best interests of the company and its shareholders. Once a director forms the view that the company is irredeemably insolvent, however, he has a legal duty to act primarily in the interests of the company's creditors, instead of its shareholders. Failure to comply with this duty can expose a director to the risk of personal liability for losses sustained by the company's creditors following any insolvency.

Typically, if a director forms the view that the company has become irredeemably insolvent, he is likely to be well advised to place the company into some form of insolvency process.

In this context, a company is irredeemably insolvent if its financial position is such that any reasonable director would conclude that it has no reasonable prospect of avoiding going into insolvent liquidation in due course.

In practice, it may not be possible to identify a precise point in time at which the company becomes irredeemably insolvent (if, indeed, the company reaches that position). Accordingly, directors are advised to:

- Continually monitor and review the financial state of the company.
- Consider the potential impact on creditors of all the decisions taken with regard to the management of the company's affairs.

WHEN AND HOW CAN A DIRECTOR BE PERSONALLY LIABLE?

If, in due course, or after seeking the advice of an insolvency practitioner, the company goes into a formal insolvency procedure such as liquidation or administration, the insolvency practitioner appointed to manage the company's affairs will usually investigate the circumstances in which the company became insolvent, including:

- Each of the directors' conduct, and the decisions that the relevant director took with regard to the management of the company's affairs.
- The transactions entered into by the company in the lead up to its insolvency.

There are a number of potential ways in which a director could become personally liable to pay money to the company, for distribution to the company's creditors, which this note explains in more detail. These causes of action include:

- Wrongful trading.
- Fraudulent trading.
- Misfeasance or breach of fiduciary duty.

- Gratuitous alienations (Transactions at an undervalue in England & Wales).
- Unfair preferences (Preferences in England & Wales).
- Personal guarantees.
- Various fraud and misconduct related offences under the Insolvency Act 1986 (Insolvency Act).

In addition, there are restrictions on the reuse of company names that, if breached, could result in personal criminal and civil liability.

You could also be made subject to a disqualification order or undertaking under the Company Directors Disqualification Act 1986 (Directors Disqualification Act).

WRONGFUL TRADING

Under the Insolvency Act, a director who allows a company to continue trading when there is no reasonable prospect that it will avoid going into insolvent liquidation may be required to contribute to the company's assets. This is known as "wrongful trading" and it is likely to be the most worrying potential personal liability.

A liquidator can apply for a court order requiring a contribution to the assets of a company from a person who is, or was, a director of a company where the company has gone into insolvent liquidation and, at some point before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company could avoid going into such insolvent liquidation.

The court will not make an order for wrongful trading if, knowing there was no reasonable prospect that the company would avoid going into insolvent liquidation, the director took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken.

A director found liable for wrongful trading may also have a disqualification order made against him under the Directors Disqualification Act (see below).

Directors cannot simply avoid the issue of wrongful trading by resigning from the company. If a director concludes that the company cannot continue to trade, he must put in place one of the insolvency procedures as soon as possible to avoid liability.

FRAUDULENT TRADING

Under the Insolvency Act if, in the course of winding up the company, it appears that any business of the company has been carried on with intent to defraud creditors, or for any other fraudulent purpose, the liquidator can seek a court declaration that anyone who was knowingly party to the fraudulent business make a contribution to the company's assets. This is known as fraudulent trading.

Fraudulent trading is also a criminal offence under the Companies Act 2006 (Companies Act). A person found liable for fraudulent trading may also have a disqualification order made against him under the Directors Disqualification Act (see below).

MISFEASANCE OR BREACH OF FIDUCIARY DUTY

Under the Insolvency Act if, in the course of winding up the company, 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 other fiduciary or other duty, the court may order the director to repay the money or property with interest or contribute such sum to the company's assets by way of compensation as the court thinks just.

GRATUITOUS ALIENATIONS - SCOTLAND (KNOWN AS TRANSACTIONS AT UNDERVALUE IN ENGLAND & WALES)

A gratuitous alienation is the transfer of property by a director, in the name of a company, to another person for no, or an inadequate consideration. In the event of an insolvent liquidation, a creditor or liquidator can challenge any such disposal of property. If a court upholds such a challenge, the property will have to be returned to the company. Gratuitous alienations are transfers of company property within the preceding five years before an insolvent liquidation in the case of transfers to “associated persons” (which can include directors and employees of the company as well as associated companies), and two years in the case of transfers to unconnected persons. If such arrangements had benefited the other commercial interests of directors or former directors, any beneficiary may see their assets or commercial arrangements reduced.

Unfair preferences - Scotland (known as preferences in England & Wales)

An unfair preference is a term applied where directors of a company enter into an arrangement whereby a preference in favour of any one creditor, to the detriment of the company's other creditors, is created. In the event that a liquidator or creditor successfully challenges a transaction as being an unfair preference, the court can grant a decree for the reduction of the contract (which means that it is treated as never having existed), or for return of property to the company. In order to be deemed an unfair preference, the arrangement must have been entered into within the six months immediately preceding liquidation and be out with the ordinary course of business. If such arrangements had benefited the other commercial interests of directors or former directors, any beneficiary may see their assets or commercial arrangements reduced.

Personal guarantees

The directors of a company are generally not personally liable for the debts of a company. If a director has given a personal guarantee in respect of the liabilities of the company, however, he may be personally liable under it.

Fraud and misconduct offences under the Insolvency Act

There are additional offences under the Insolvency Act that can apply to directors, such as falsification of a company's books and false representations to creditors.

Directors disqualification and insolvency

Under the Directors Disqualification Act, a court may make a disqualification order against a person that he shall not, without leave of the court, be a director of a company or in any way be concerned or take part in the promotion, formation or management of a company for a specified period.

A disqualification order may be made against a director of a company which becomes insolvent if his conduct as a director makes him unfit to be concerned in the management of a company. The minimum period of a disqualification order is two years and the maximum is 15 years. A disqualified director can apply to the court for leave to act as a director and manager of a company.

It is a criminal offence if a person acts in contravention of a disqualification order and that person will be personally liable for all the relevant debts of the company he is managing.

The Secretary of State for the Department of Business, Innovation and Skills may, instead of initiating disqualification proceedings, accept a voluntary disqualification undertaking from a director. The advantage to directors of giving a voluntary disqualification undertaking is that they will not need to pay the costs of going to court and may also be given a discount on the length of any disqualification period. A breach of a disqualification undertaking has the same criminal and civil consequences as a breach of a disqualification order.

Restriction on reuse of company names

Under the Insolvency Act, there is a restriction on the reuse of company names. This applies where a director or a shadow director of a company that has gone into insolvent liquidation either (i) operates without leave of court or (ii) doesn't follow a creditor notification procedure under the Insolvency Act, as a director or shadow director of a new company with a similar name to that of the insolvent company in the five-year period following the date of insolvency. The penalties if found liable include imprisonment, a fine or both, together with personal liability for the debts of the new company.

Practical steps

This note sets out the issues that director ought to be aware of in relation to a company which is, or begins to experience financial difficulties.

Directors who find themselves in a situation where they are concerned that the company is facing, or may be likely to face financial difficulty, are advised to keep matters under continual review. In particular, it is prudent to:

- Hold frequent board meetings convened specifically for the purpose of reviewing the company's financial position and keep proper minutes of those meetings, noting in particular any decisions made and the reasons for them.
- Maintain accurate and up-to-date company financial records.
- Continually monitor the company's financial position and future cash flows and consider ways to reduce expenditure.
- Take professional advice aimed at reviewing whether insolvent liquidation is inevitable or whether there is some way of resolving or mitigating the company's financial difficulties.
- View resignation as a last resort, but if it becomes unavoidable, minute dissent with other directors at a full board meeting and set the reasons out again in a resignation letter to the whole board.

For further details, please contact:

Stuart Hendry

Kenny Mumford

Tracey Ginn

Michael Arnott

Tel:

Edinburgh: 0131 226 8200

London: 0203 962 1796

E-Mail:

stuart.hendry@mbmcommercial.co.uk

kenny.mumford@mbmcommercial.co.uk

tracey.ginn@mbmcommercial.co.uk

michael.arnott@mbmcommercial.co.uk