DIRECTORS' DUTIES HOW TO DEAL WITH THREATENED INSOLVENCY

If a company is insolvent or in danger of becoming insolvent, it is essential that directors are aware of the duties they owe to creditors, and of the things they should and should not do.

It is important to note that, in certain circumstances, personal liability can be imposed on directors of companies which go into insolvent liquidation, and so it is imperative that directors act correctly to minimise any such risk. This is a brief checklist of key issues to consider.

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Directors are subject to statutory duties under the Companies Act 2006
In particular, they must promote the success of the company for the benefit of its shareholders. However, the emphasis changes if the company is insolvent or is approaching insolvency. In that situation, directors must put the interests of creditors as a whole before those of shareholders. The precise details of what factors they should take into account to discharge those duties will vary from case to case and they should seek professional advice if in any doubt.

Directors should ask themselves on a regular basis whether their company remains solvent
There are two alternative tests. Applying the "cash flow" test, a company is insolvent if it cannot pay its debts as they fall due. Applying the "balance sheet" test, a company is deemed insolvent if its liabilities (taking into account its contingent and prospective liabilities) exceed its assets. The Supreme Court has provided some clarity on the "balance sheet" test, rejecting the Court of Appeal's "point of no return" approach, holding that the court has to be satisfied, on the balance of probabilities, that a company has insufficient assets to meet all its liabilities (including contingent and prospective liabilities) as and when they eventually fall due. Following the Supreme Court's decision, the two tests are not entirely distinct with the balance sheet test now apparently becoming a longer term "cash flow" test. If directors think their company may be insolvent on either test, duties are owed primarily to creditors as a whole.

Directors are obliged to consider whether the company should continue to trade if it is insolvent
Personal liability can attach to the directors for wrongful or fraudulent trading, such that the directors can be ordered to contribute to the assets of the company. Directors can be liable for wrongful trading where they continued trading at a time when they knew (or should have concluded) that there was no reasonable prospect of the company avoiding an insolvent liquidation and they failed to take every step a reasonably diligent person could be expected to take to minimise loss to creditors. Fraudulent trading occurs if it appears that any business

of the company has been carried on with intent to defraud creditors or for any fraudulent purpose. It can be sufficient to show that a company continued to carry on business and to incur debts at a time when there was, to the knowledge of the directors, no reasonable prospect of those debts being paid. Fraudulent trading is also a criminal offence, punishable by a fine or imprisonment.

Transactions completed in the run-up to insolvency can be challenged by the courts and, in some cases, the courts can overturn them

Directors should be very careful if they plan to transfer assets out of a company if there is any doubt as to whether it is solvent. If the company enters into a transaction below market value (for example it sells an asset at a knock down price), there is a risk that a subsequently appointed liquidator or administrator of the company may seek to set aside the transaction as a transaction at an undervalue. In addition, care should be taken to avoid doing anything which may put a creditor in a better position than it would be in on an insolvent liquidation. If the company, for example, pays the whole or part of a debt in priority to other debts or grants security for an existing debt, and the company later goes into insolvent liquidation or administration, the transaction could be set aside as a preference. Directors may also be found liable for breach of duty for causing the company to enter into a transaction at an undervalue or a preference.

Directors should take particular care if a group of companies is involved

Directors of multiple companies in a group should bear in mind that transactions within the group can be more vulnerable to challenge than transactions between group companies and third parties. A director who is the director of several companies within a group owes his duties to each particular company. When a group is poor financial health, conflicts may develop. For example, allowing group funding practices to continue which may have made sense in a time of financial health (such as diverting cash from one company to another via a group cash pooling mechanism) may be open to attack in an insolvency, if an insolvent company is thereby deprived of assets. A director could be liable for breach of duty for allowing such a practice to continue. Directors should also carefully consider whether any transactions might be construed as a preference or a transaction at an undervalue, for example repaying intragroup loans ahead of other creditors or granting guarantees in respect of liabilities of other group companies.

The following practical steps should be taken:

- **Board meetings should be held regularly**

Ensure that all directors, or as many as possible, are present so that the whole board can be fully briefed on the financial situation. If directors cannot attend in person, consider attendance by telephone at board meetings.

- **Full board minutes should be taken (and circulated to all directors after the meeting)**

These will evidence whether or not the steps taken by the board minimised the potential loss to creditors and will help defend the directors in any allegation of wrongful trading. A detailed paper trail will be very important if the company goes into insolvent liquidation in showing that the directors had assessed the situation properly, taken timely professional advice on their duties to the company and to creditors, and had acted accordingly.

- **Keep up to date management accounts and prepare regular cash flow forecasts**
- **Directors to take prompt professional advice if they have any concerns**

KEY CONTACTS

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