Directors and Corporate Insolvency

All directors owe fiduciary duties to their company and its members (**"Stakeholders"**). Directors who breach their duties or who deal with assets inappropriately during distressed financial periods potentially face personal claims for associated losses. When a company becomes insolvent, the duty to act in the best interest of the Stakeholders moves to act in the best interests of the company's creditors, although such time period is called the "grey zone" or "zone of insolvency" due to its opaque nature (however, recent case law has brought more clarity to the area - *BTI 2014 LLC v. Sequana SA and Others [2022] UKSC 25*). Directors must take all reasonable steps, a high bar, to protect the financial interests of the company's creditors if they want to avoid personal liability.

In the UK, a company can be balance sheet or cashflow insolvent. Balance sheet insolvency is where a company's total liabilities exceed its total assets. In certain scenarios, directors can continue to trade companies that are balance sheet insolvent with limited potential exposure, as there is a general understanding that day to day creditors can be managed and there is a reasonable prospect the assets will at some point exceed the liabilities (eg. a property development company pre-completion of an asset).

Cashflow insolvency is the inability of a company to pay its debts as they fall due. This situation can arise due to events outside a company or director's control, and therefore sufficient visibility, cash management and the ability to obtain quick additional liquidity are key parts of trading a business. The threshold for a creditor to issue a winding up petition against a company for an unpaid debt is only £750. However, the potential negative repercussions such petition can have on the ongoing viability of a company can become acute very quickly if not properly managed. Commercially agreeing to defer payments with creditors and suppliers is an acceptable course of action, if practicably achievable, but care should be taken to adhere to new terms, especially with HMRC, who have started to take more aggressive action for non-payment of taxes.

Who are Directors?

For the purposes of the Companies Act 2006 (**"Companies Act"**) and the Insolvency Act 1986 (**"Insolvency Act"**), the word "director" covers "any person occupying the position of director, by whatever name called". The definition includes de jure directors (directors that have been formally appointed as such and registered at Companies House), de facto directors (people who assume responsibility to act as a director although they have never been formally appointed) and shadow directors (people in accordance with whose directions or instructions the directors of the company are accustomed to act).

What Duties do Directors Owe?

The Companies Act codifies the statutory duties of directors. A breach of any of these duties will potentially give rise to a claim by the company (or derivatively, its shareholders) against a director personally. The duties are as follows:

- To act within their powers.
- To promote the success of the company.
- To exercise independent judgment.

- To exercise reasonable care, skill and diligence.
- To avoid conflicts of interest.
- Not to accept benefits from third parties.
- To declare any interest in a proposed transaction or arrangement with the company.

These general duties are supplemented by numerous other duties which also expose directors to the prospect of personal liability (eg. environmental and health and safety legislation).

How are Directors Exposed in Insolvency?

Directors of companies that are facing financial difficulties may face civil and criminal liability. An insolvency practitioner appointed to a company which has entered into administration or insolvent liquidation can look at the past actions of directors and consider whether a claim could be brought against directors to increase assets for distribution to creditors of the company. The key claims that can be made against directors are as follows:

- **Wrongful Trading**. If it appears that a director knew or ought to have concluded at some point in time that there was no reasonable prospect that the company would avoid going into administration or insolvent liquidation, the liquidator or administrator can seek an order requiring a director to contribute towards the assets of the company in an amount that equates to the additional liabilities incurred due to the directors continuing to trade the company from such time.
- **Reviewable Transactions**. Whilst a company is in a stressed financial position, directors may undertake transactions to attempt to resolve the situation. However, certain actions during this time can be reviewed by an insolvency practitioner, which may expose the directors to clawback claims. Such transactions may include (i) Preference: (eg. requiring the company to repay a director's loan account); (ii) Transaction at an Undervalue (eg. transferring a company asset to another company for nil consideration); (iii) Exorbitant credit transaction (eg. accepting new supply terms from an existing supplier on more onerous terms); (iv) Invalid floating charges (eg. granting new floating charge security to an existing lender with no additional money provided); (v) Transactions defrauding creditors (insolvency is not a strict requirement for this claim).
- **Misfeasance (Breach of Fiduciary Duty)**. If it appears that a current or former director is guilty of any breach of any fiduciary or other duty, the court may order the director to repay, restore or account for any money or property lost with interest or contribute to the company's assets.
- **Fraudulent Trading**. If it appears that any business of the company has been carried on with the intent to defraud creditors, the administrator or liquidator can seek a court order requiring any person who was knowingly party to the fraudulent business contribute to the company's assets. Fraudulent trading is also a criminal offence. There are various further offences under the Insolvency Act arising from fraudulent actions that would also give rise to criminal liability.
- **Director Disqualification**. If a director's conduct makes them unfit to be involved in the management of a company (especially where the director has been found liable for fraudulent or wrongful trading) they may be disqualified for a minimum of 2 years.

How can Directors Protect Themselves?

There are various defences for directors to mitigate potential liability, which should be actively considered in a distress scenario. However, certain actions, although proactive on the face of it, may have give rise to liability if not properly considered.

a. Take advice. It is good practice (and arguably a fiduciary duty) for a director to take appropriate advice if they anticipate financial difficulties on the horizon. If the situation is more serious and there may be no reasonable prospect of the company avoiding administration or insolvent liquidation, the board (or an individual director, if the board is of a different view) should look to immediately take independent legal or financial advice from an appropriately qualified professional. From this time, directors should be taking every possible step to minimise any potential loss to creditors (see "*Continue to trade?*" below). Failure to be able to evidence that such actions were taken could lead to personal liability for directors. All directors will be considered to have the same knowledge, so ignorance of any issues known to another director is no defence (see "*Record everything*" below), nor is arguing that they had a deficiency of skill or knowledge.

b. Record everything. If the company is in financial difficulties the directors should call regular board meetings and ensure that all commercial decisions are recorded in full in the company's minutes. All directors should be aware of the situation and up to date financial information should be readily available (see "*Current financial position*" below). Directors should reach their commercial decisions independently (see "*Take advice*" above and "*Resignation*" below) and any consensus or disagreement between directors should be clearly noted. Any commercial renegotiation of contracts with creditors (including HMRC) or suppliers should be recorded in writing.

c. Continue to trade? Liability for wrongful trading cannot arise unless the company continues to trade following the date there is no reasonable prospect of the company avoiding administration or insolvent liquidation. Ceasing to trade before this time would potentially reduce the risk of such liability arising, although it should be noted that a company cannot simply cease to trade unless the company is solvent and can pay off all its debts (including actual, contingent and prospective debts). Managing cashflow at this time is crucial to avoid a creditor issuing a winding up petition for unpaid sums (especially if creditors are already being stretched), which may precipitate a snowball effect of further solvency issues (eg. financial covenant or contractual breaches). Borrowing new money from secured creditors on normal commercial terms to enable the company to continue to trade should have no direct impact on wrongful trading considerations, although advice should be taken to consider specific circumstances (and may not be practicable if there is already secured debt in the company). In certain scenarios, directors should themselves commence formal insolvency processes to manage an insolvent wind down of a company.

d. Current financial information. Clearly, when there are potential cashflow issues, access to up-to-date financial information is crucial. Generally, cash flow forecasts should give directors visibility of potential crunch points and future payment requirements (see *"Continue to trade?"* above), but if the unexpected was to suddenly occur, sufficient focus and effort should be given to ensure accurate and detailed financial data is readily available.

e. Resignation? Generally speaking, resigning as a director from a company in financial difficulties will not protect such director from the court or appointed insolvency practitioner looking back at the director's

actions. Indeed, resignation at such time is arguably a breach of a director's statutory duties to promote the success of the company. However, where a director independently forms the view that there is no reasonable prospect of the company avoiding administration or insolvent liquidation, but the board have a differing view (see *"Record everything"* above), this may justify resignation.