PENNINGTONS MANCHES

FASHION AND LUXURY BRANDS TURNAROUND MANAGEMENT FACT SHEET

For any company there is always the risk of getting into financial difficulties and the threat of insolvency. Whist day to day management of the business at such a time can be challenging in itself for the directors, it is important they also have regard to the various duties and restrictions placed on them and the company in such a situation, otherwise they risk facing personal liability.

DIRECTORS DUTIES

In very general terms, directors owe their duties to the company they act for, which is a separate legal entity, and not to the individual shareholders or members. The Companies Act 2006 contains seven general duties which directors must abide by. In a potential insolvency situation the most relevant of these duties is the duty to promote the success of the company for the benefit of the shareholders as a whole.

When a company is clearly solvent this duty is for the benefit of the shareholders, the owners of the company. However, when that company is insolvent, or even when that company's solvency is doubtful, that duty shifts and the directors are under a duty to consider the interests of the company's creditors above the interests of its shareholders. As a result, the directors must not assume any shareholder ratification or approval for their actions, which may be damaging to the interests of the creditors, will absolve them of liability.

SHADOW DIRECTORS, DE FACTO DIRECTORS AND NON-EXECUTIVE DIRECTORS

It is important for the directors to understand that the duties and potential liabilities upon a company director under the Insolvency Act 1986 (the 1986 Act) apply equally to shadow directors, de facto directors and non-executive directors as they do to executive directors.

Shadow directors

The definition of a shadow director is extremely wide and includes any person in accordance with whose directions or instructions the directors are accustomed to act. This definition does not however cover any advice given in a professional capacity.

De facto directors

A 'de facto' director is a person who has not been formally appointed as a full director but has acted as if he was a director of the company.

Non-executive directors

Non-executive directors may find that they are as much at risk under the wrongful trading provisions as executive directors. The risk to a non-executive director will very much depend on their level of involvement in the decision making process and the information made available to them by the executive directors.

THE TESTS FOR INSOLVENCY

A company will be regarded as insolvent by application of one or both tests for insolvency, known as the 'cash flow' test and the 'balance sheet test'. In summary:

- **the cash flow test** – is where the company is unable to pay its debts as they fall due; and
- **the balance sheet test** – is where it is proven to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

When assessing certain contingent and prospective liabilities, it is not necessarily correct to put these in the balance sheet at the full value of the potential liability immediately (unless such liabilities were almost certain to be incurred) but rather, due consideration would need to be applied to all of the quantum of the liability; likelihood of the liability being incurred; as well as when this might occur. An entry, if any, should then be made on the balance sheet on this basis.

WRONGFUL TRADING

The most common concern for a company's directors faced with a potential insolvency is wrongful trading. This is where a company has gone into insolvent liquidation and it can be shown that before the commencement of the winding-up the director knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation.

Even if the directors decided that there was no reasonable prospect that the company would avoid insolvent liquidation that would not necessarily mean that they should immediately file for some form of insolvency procedure. Rather, they should ensure that they then take every step with a view to minimising the potential loss to the company's creditors that they ought to in the circumstances. In practice, that generally means liaising closely with major creditors of the company as to the timing of any insolvency process so as to try to maximise the return to the company's creditors.

In determining what a director knew or ought to have known, they will be judged on the basis of a reasonably diligent person having both:

- the general knowledge, skill and experience that can be reasonably expected of a person carrying out the functions of a director (ie the reasonable company director); and
- the general knowledge, skill and experience that he in fact possesses.

In circumstances where the court deems a director to be guilty of wrongful trading, the director can be required to make such contribution towards the debts or liabilities of the company as the court thinks proper.

The only defence open to a director is that he took every step with a view to minimising the potential loss to the company's creditors that he ought to have taken, albeit this first assumes that he knew or ought to have known that there was no reasonable prospect that the company would avoid insolvent liquidation. The onus is on the director to prove this defence but it is up to the liquidator to prove the latter.

It should be noted that merely resigning will not of itself relieve a director from liability if he was a director at a time when the liquidator can show that he knew or should have concluded that insolvent liquidation was inevitable.

FRAUDULENT TRADING

If any business of a company is carried on with the intent to defraud creditors or for any other fraudulent purpose, the liquidator of the company can apply to the court for a contribution from any person who was knowingly a party to the carrying on of the business in that manner. This provision is not often invoked since it requires fraudulent conduct, ie a deliberate intention to carry out the intended conduct with a view to the other party acting to its detriment. However, where the directors allow a company to continue to trade and incur liabilities when they know there is no real prospect that these will be repaid, the directors are at risk under this provision.

It should also be noted that this provision is wider than the wrongful trading provision in that it applies to 'any persons', not just directors, who were knowingly parties to the carrying on of the business in question. There is also no defence of taking steps to minimise loss to creditors. Fraudulent trading also attracts a criminal penalty of up to seven years' imprisonment or an unlimited fine, or both, as well as civil liability.

TRANSACTIONS AT AN UNDERVALUE

Where a company has entered into a transaction at an undervalue within two years prior to its going into liquidation or administration, the court may make an order on application by the liquidator or administrator to restore the position to what it would have been had the company not entered into the transaction.

A transaction will be regarded as being at an undervalue if the company involved does not receive any consideration for the transaction or the value of the consideration it receives is significantly less than the value of the consideration it provided.

A defence is available if the court is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business and at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company.

PREFERENCES

Where a company has given a preference within six months before the liquidation or administration (or within two years if it is to a 'connected' person), the court may make an order on application by the liquidator or administrator to restore the position to what it would have been had the company not given the preference.

A 'preference' occurs where a company does anything, or allows anything to be done, which puts one of its creditors, sureties or guarantors into a better position than he would have been in if that act had not been done. Examples of preferences include:

- payment of one creditor in full or in part when others remain unpaid; and
- granting security in respect of existing debts.

A transaction can only be set aside under this provision if the company can be shown to be 'influenced by a desire' to prefer such creditor (surety or guarantor). It is not sufficient for the liquidator or administrator to show that the company was merely aware that the transaction would put a creditor in a better position - a positive wish to achieve this end is needed.

MISFEASANCE

Section 212 of the 1986 Act provides for a remedy against directors and other officers and persons involved in the promotion, formation or management of a company who have misapplied, retained, become liable or accountable for any money or property of the company, or have been guilty of misfeasance, breach of fiduciary duty or any other duty in relation to the company concerned.

The court may examine the conduct of such persons and compel them to repay or restore the money or the property with interest or to contribute money to the assets of the company by way of compensation.

This remedy covers a variety of actions, including the improper payment of dividends, the application of monies for ultra vires purposes and any unauthorised loans or payment of unauthorised remuneration to directors.

A court may grant relief from liability for negligence, breach of duty or breach of trust if the director has acted honestly and reasonably and if, having regard to all of the circumstances of the case, he ought fairly to be excused. Whether the court will grant relief will depend on what view the court forms of the conduct of the director in the particular case.

TRANSACTIONS DEFRAUDING CREDITORS

Where a person enters into a transaction at an undervalue with the purpose of putting assets beyond the reach of the person who is making, or may at some time make, a claim against him, or of otherwise prejudicing the interests of such a person in relation to a claim, the court may make an order to restore the position to what it would have been if the transaction had not been entered into and to protect the interests of persons who are victims of the transaction.

There is no fixed period within which a transaction must have occurred nor is it necessary for the company to have begun any insolvency process for a transaction to be liable to be set aside under this section.

It should also be noted that this remedy is not limited to liquidators and administrators but is available to any 'victim' of the transaction as set out above.

UNLAWFUL DISTRIBUTIONS

A transaction with or payment to a shareholder, such as the shareholder's loan, may also be regarded as an unlawful distribution of a company's assets. Assets may be distributed to a company's members only if there are distributable profits available for this purpose (being accumulated realised profits, so far as not previously utilised by distribution or capitalisation, less accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital).

If there are insufficient distributable reserves, a transaction with or payment to a shareholder could constitute an unlawful distribution of capital.

DISQUALIFICATION

If the court makes a declaration under any of the above provisions, it may also make an order to disqualify the relevant director from being in any way concerned in the management of a company for a minimum period of two years.

The above summary is not intended to be an exhaustive summary of directors' duties but to highlight those which may be particularly relevant when the solvency of the company may be in issue. Other duties should not be overlooked, for example the duty to keep proper accounts and the duty to disclose an interest in transactions with the company.

FIND OUT MORE

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