Directors' Duties:
Companies in Financial Difficulty

Preliminary

The purpose of this Fact Sheet is to brief the owner-manager on the duties and liabilities of a director whose company is in financial difficulty.

The Starting Point: Good Independent Objective Advice

The starting point is to understand that you are not alone! Every day of every week of the year businessmen and businesswomen are grappling with the same problems that you are facing: how to respond to cash flow pressures. These may be caused by negative short term factors (e.g. a problem contract) or negative long term factors (e.g. increased competition) or by positive factors (e.g. the need for extra cash to provide working capital for new contracts).

So because these problems are commonplace there are people out there who can help you. Taking objective independent advice from a business adviser (such as an accountant or solicitor) or an insolvency practitioner (see below) will often be the first step that should be taken.

To advise you properly any such adviser must know all relevant facts. So you must take the time to brief the adviser fully.

A word of caution: if you do not have a trusted business adviser you can turn to, be careful from whom you seek advice. Those in financial difficulty may be easy prey to the unscrupulous. Unregulated advisers may encourage dubious or unlawful conduct and may be less interested in your interests than in their own ability to generate fees.

So look for personal recommendations and do not be shy about asking advisers to provide references. Also most advisers will be happy to provide two or three hours of initial advice without charge. This can be a good way to assess the adviser's capability and decide whether you could work with that person.

What is insolvency?

A few preliminary words on what is insolvency may be helpful. There are two sorts of insolvency.

First, balance sheet insolvency: this is where the company's liabilities exceed its assets. Secondly, cash flow insolvency: this is where a company cannot pay its debts as they fall due.

Cash flow insolvency can lead to balance sheet insolvency; if a company has to cease trading because it cannot pay its bills as they fall due the value at which it is carrying its assets may need to be written down to their forced sale value instead of being shown at their going concern value.

Many companies that are balance sheet insolvent can continue to trade happily provided they have the support of key creditors such as their banks.

When larger companies get into financial difficulty you may read comments in the press about their having or being in danger of breaching their banking covenants. These are the ratios that the bank has set as the condition for providing loan or overdraft facilities (e.g. the number of times debt interest is covered by profits or the debt relative to the net asset value). For smaller companies overdrafts are almost invariably on-demand and will generally be backed by directors' personal guarantees.

Different insolvency procedures

The very word 'insolvency' can be threatening but please read on. Several of these procedures can be used to save a business so it is important that you have an idea of the options available.

1. Administration

This procedure is equivalent to the "Chapter 11" Rescue Procedure available in the US. It provides the company with protection from its creditors; so for example any winding-up petitions are put on hold, finance houses cannot repossess motor cars and machinery. Also HM Revenue and Customs cannot take possession (known as distraint) of plant and equipment and stock.

This can give the company the breathing space to raise new funds, to perhaps reach agreement with its creditors on deferred (or reduced payment) of existing debt or give time to sell the business.

Administration involves an insolvency practitioner (someone licensed by one of several professional bodies including the Institute of Chartered Accountants of England and Wales and the Insolvency Practitioners Association) taking responsibility for the business. So directors lose their powers to run the business in favour of the administrator: a step which an owner manager will not want to take lightly.

The overriding duty of the administrator is to save the business as a going concern, if possible. An administrator can be appointed by the company or by a bank holding a debenture. Since the Enterprise Act 2002 came into force administration must be used (rather than administrative receivership, see below) by banks holding debentures entered into after 15 September 2003 except for certain exceptional cases (e.g. capital market transactions).

2. Administrative Receivership

An administrative receiver is an insolvency practitioner appointed by a bank (or other secured lender) who has taken a debenture with a floating charge; that is a general floating security over assets such as stock, machinery and (perhaps) book debts. He has power to run the business and sell the business and its assets.

The overriding duty of the administrative receiver is to pay off the bank (or other secured lender) who has appointed him.

Since the Enterprise Act 2002 came into force the administrative receivership has been a less used procedure. This is because (save for exceptional cases) banks who have taken debentures since 15 September 2003 must appoint an administrator whose job (see above) is to try and save the business.

3. Corporate Voluntary Arrangement

This procedure needs to be supervised (but not controlled by) an insolvency practitioner. It can be used to compromise (or settle) creditor claims so that, for example, creditors receive a delayed payment or a reduced payment of so many pence in the pound, through a binding agreement.

The procedure involves the preparation of a proposal and the convening of a creditors' meeting to vote on the proposal. A 75% vote (by value of debt held) of the creditors is needed for the proposal to be passed. It is then binding on all creditors.

This can be a powerful procedure for a company running a business that has suffered an unexpected problem but is otherwise viable (e.g. a major bad debt).

4. Compulsory Winding-up

This is the procedure taken by a creditor who is owed at least £750. It is generally preceded by the making of a 21 day statutory demand: failure to pay a bona fide debt after a 21 day written demand gives grounds to start the winding-up procedure by issuing a winding-up petition.

This procedure involves the appointment of a liquidator who is normally the Official Receiver: a civil servant. The role of the liquidator is to collect in the assets and pay off the debts of the company, distributing any surplus to those entitled to it. He has ancillary powers to run the business but will not have the resources (or skills) of the administrator.

5. Members' Voluntary Liquidation

This is a procedure initiated by a (75%) vote of the shareholders of the company for the appointment of a liquidator. There are two varieties:-

(i) Creditors' Voluntary Liquidation (CVL)

This applies where the directors are unable to make a declaration of solvency. The liquidator is usually an insolvency practitioner chosen by the directors but it can be the Official Receiver (a civil servant) if no insolvency practitioner is available or willing to act.

(ii) Members' Voluntary Liquidation

This is the same as for the CVL except that it is preceded by a Directors' declaration of solvency and there is no need for a creditors' committee.

The role of the liquidator in either case is to collect in the assets and pay off the liabilities. The liquidator also has power to give up (or disclaim) onerous property such as an unprofitable contract or lease liabilities.

Different insolvency procedures

Having given an overview of the alternative insolvency procedures open to the company it is necessary to turn to the issues of personal responsibilities, liabilities and risks. We will start with fiduciary duties and wrongful trading because these are the key areas of responsibility and risk that need to be understood. We will then look at some practical tips on managing the risk and then deal with some related issues.

Fiduciary duties

Directors must act bona fide in what they reasonably consider to be the best interests of the company. They must act honestly, diligently and for a proper purpose and not allow their personal interests to conflict. They also owe a duty of skill and care.

Wrongful trading

The law here can be simply put: it applies if a director allows a company to continue trading and taking credit from suppliers when no-one could reasonably have thought the company could avoid insolvent liquidation. If a Director does so he can be made personally liable for those additional liabilities:

In practical terms this means:

- Taking independent professional advice as soon as possible.
- Ensuring there is up-to-date financial information; in addition to normal monthly management accounts and cash flow projections, a weekly cash flow may be advisable;
- Being careful not to take goods or services on credit if the financial position of the company is very uncertain;
- Ensuring that the basis for any decision to continue trading is carefully documented and minuted by the Board;
- Considering the possible use of one of the insolvency procedures described in the section above entitled Different Insolvency Procedures.
- Legislation enacted in connection with the COVID-19 crisis has suspended the wrongful trading liability. Duties may, though, still be owed to creditors which might be enforced by a liquidator.

If a company goes into one of these insolvency procedures its Directors will be asked to fill in a detailed form. This will seek to establish what financial information the Board had to hand and on what basis they acted as they did. Documenting

decisions formally will help directors to answer the questions in this form and avoid disqualification proceedings (see below).

Disqualification

The Department for Business, Energy and Industrial Strategy (formerly the DTI) has power to bring proceedings to disqualify a person from acting as a director. Breach of fiduciary duty or allowing a company to trade wrongfully can lead to disqualification.

Allowing a company to trade wrongfully would be grounds for such proceedings as would other unlawful actions (see below).

Preferences

Where a company is in financial difficulties, directors should not deal more favourably (or prefer) one creditor or group of creditors. Again, the directors should take and act on professional advice.

At first sight paying employee salaries when other suppliers are not being paid may seem wrong. However, the key issue will be why the payment is being made; if it is made, not with the intention of preferring the employees, but because the future viability of the business depends on employee support and confidence, then payment can almost certainly be made provided the Board reasonably believes the company can survive.

Self-Dealing by Directors

Sometimes directors may choose to buy assets from a company in financial difficulty in order to provide a cash injection.

Care should be taken before doing this. First, the transaction should be on arms' length terms and if not could be set aside on the basis of a transaction at an undervalue if the company goes into insolvent liquidation. Secondly, it is likely that formal shareholder approval will be needed; failure to obtain that approval will again leave the transaction vulnerable to being set aside by a liquidator.

Phoenix Companies

Suppose a company fails, can the directors simply start trading again using a company with the same or a similar name?

The answer is that if a company has gone into insolvent liquidation a Director will commit a criminal offence if his new company uses the same or a similar name for the next 5 years. There are exceptions to this prohibition; in particular if substantially all of the company's assets have been bought from an administrator or liquidation and creditors have been circularised so they are aware of the director's connection with the failed business.

False Accounting

The onset of financial difficulties may be a temptation to present the financial position of a company more favourably than should be the case (e.g. by over-valuing stock or recognising income too early). Great care must be taken that what might otherwise be characterised as *window dressing*, does not become false accounting. This is a criminal offence.

Fraudulent Trading

Those who allow a company to trade dishonestly with an intent to defraud creditors, will commit the criminal offence of fraudulent trading.

Resignation

A Director who is not happy with the way in which a company is being run may need to consider resigning his Directorship. Care must be taken, however.

In circumstances where the key director or directors resign without having first initiated one of the insolvency procedures described in the section above entitled Different Insolvency Procedures, they may have failed to meet their obligations as Directors.

Final thoughts

For a businessman or woman who has put their heart and soul into a venture, the poor financial performance of that business will be a very stressful experience. The insolvency of such a business is sometimes likened to a bereavement.

The co-directors' family and the friends of such a businessman should recognise these intensely personal issues in offering their help and support.

I have to say that you and your team have shown us the way when it comes to perseverance and tenacity.

Martin Todd
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Do you need more information?

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