Compliance with directors' duties under threat of insolvency

A practical guide for directors of UK companies | 2022
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The purpose of this note

The profound business and market interruption caused by the Covid-19 outbreak introduced insolvency risks for many otherwise healthy businesses. Those that were able to ride out the peak of the pandemic will now face further challenges as a result of the impact of Brexit, the ongoing cost of living crisis and the general economic uncertainty in 2022.

This note summarises the key concerns for boards facing those risks – either directly, or within their customer and supplier networks. It updates our earlier note published on 30 March 2020.

This is a general note, for information purposes. If you require more detailed advice on your specific circumstances, please contact a member of TLT's UK-wide Restructuring and Insolvency team, whose details are set out at the end of this note.

Company insolvency

When is a company insolvent?

In general terms, a company is insolvent if it is unable to pay its debts as and when they fall due.

A company may also be considered to be insolvent if the value of its assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities.

Why is it important to know when a company is (or might be) insolvent?

When a company is (or might be) insolvent the directors' primary duties will shift from protecting the interests of the company (and its shareholders) to prioritising the interests of creditors ahead of all others. This is the case even if the company's circumstances fall short of actual, established insolvency.

Any liquidator or administrator who is subsequently appointed will investigate the directors' actions in the period leading up to insolvency and report on these to the Insolvency Service, a UK Government agency. Directors risk personal liability for a company's debts, disqualification and even imprisonment if it is found that they have acted in breach of provisions designed to protect creditors during this period.

Insolvency also typically triggers defaults and termination rights under banking facilities and key commercial contracts. This may exacerbate risk, destroy value and undermine trading.

An insolvent business is particularly exposed to the risk of a winding up petition, which can result in bank accounts being frozen and curtails the ability to trade. During the Covid-19 pandemic, temporary restrictions were put in place which reduced the risk of a winding up petition being presented by a creditor. These restrictions have, for the most part, now expired. If the company is served with a winding up petition or statutory demand, legal advice should be sought as soon as possible.

What should the board do if a company is (or might be) insolvent?

Plan. If a company's solvency is in doubt, its board should be assessing its prospects and devising and implementing turnaround and contingency plans to comply with their duty to creditors. Information will need to be updated and plans may need to be revised, as circumstances change.

Take advice. Professional advisers will need as much accurate and up to date information as possible, regarding the company's current and projected financial position. This will include accounts, valuations, cash-flow forecasts and creditor profiles.

Document. It is really important that boards document their decision making during this period.

Directors' duties

What are a director's duties?

The directors' duties regime did not change as a result of the pandemic. Each director must continue to abide by seven statutory duties:

- 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; and
- To declare an interest in proposed transactions or arrangements.

How do these duties change when a company is (or may be) insolvent?

When a company is **solvent** its directors owe their duties to the company, for the benefit of its shareholders as a whole.

When a company **is (or might be) insolvent** the directors remain subject to all of the usual statutory duties but will also need to begin to take the interests of the creditors into account when managing the company and its business. This duty to take the creditors' interests into account works on a "sliding scale" basis, whereby directors, when considering the duties that they owe to the company, must balance the interests of creditors against the interests of shareholders, with increasing emphasis on the interests of creditors as the company's financial difficulties, and the probability of entering an insolvency process, increase. This is because, unless and until the company returns to solvency, the creditors have the primary economic interest in the decisions that the directors make.

When a company is **insolvent** and its directors know (or ought reasonably to have concluded) that the company will not avoid insolvent liquidation or administration, they are under a duty to take every step which a reasonably diligent person would take to minimise potential loss to the company's creditors. If they do not do so and the company subsequently goes into insolvent liquidation or administration, the directors may be liable for **wrongful trading**. They risk personal liability for any worsening of the company's financial position if the court orders them to make a contribution to the company's assets.

As part of its response to Covid-19, on 28 March 2020 the Government announced that it would be temporarily suspending wrongful trading provisions during the pandemic. However, this was not, in fact, the effect of the new legislation. Instead of suspending the wrongful trading provisions, the court was directed to assume that a director was not responsible for any **worsening of the financial position** of the creditors or the company that occurred between 1 March and 30 September 2020. So, a contribution order can still be made against a director trading an insolvent company during this period, but may potentially be reduced in amount.

How can directors ensure that they are acting in accordance with their duties?

Shareholder ratification or sanction will not be sufficient to discharge directors' duties if a company is insolvent and an action is not in the creditors' best interests. Directors must not act for any personal or collateral purpose.

Decisions to incur further credit should only be made if it is believed that this is in the best interests of the creditors as a whole and supports a turnaround plan.

Creditors must not be misled about the company's financial position and the prospects of repayment when a company is incurring further credit.

Where possible, advice should be taken before actions are finalised and implemented.

Can a company continue to trade if it is (or may be) insolvent?

It is possible for a company to continue trading even if there is a threat of insolvency. In some cases, this may be the most appropriate course of action and will be in the best interest of creditors as a whole.

Directors must remain constantly alert to the risks in any case where their action or inaction may be increasing avoidable losses for creditors. The temporary provisions mitigating the amount of contribution that may be required from directors in relation to losses incurred between 1 March and 30 September 2020 do not prevent the court from finding that there was wrongful trading and making a contribution order for losses arising outside of this period.

The UK Government's Insolvency Service retains the power to seek the disqualification of directors for a wide range of misdemeanours and to apply for compensation orders. Its press release announcing the planned changes to the wrongful trading regime specifically referenced disqualification as "**an effective deterrent against director misconduct**".

Can a company still pay dividends to its shareholders if it may be insolvent?

A company must have profits available in order to make a distribution. Its directors should take expert advice before making any distributions to shareholders or anyone connected to shareholders while the company's solvency is in question.

The payment of a dividend may in some circumstances be open to challenge. The company does not need to be insolvent for such a challenge to be brought.

A director who authorises an unlawful distribution may be in breach of their duties and may be personally liable to repay the company.

Practical advice

Do the changes to wrongful trading laws during the pandemic mean that directors can allow companies to continue to trade without any risk of personal liability or criticism?

No. The changes only mitigated the extent to which an order can be made requiring directors to contribute to the assets of a company where there is a finding of wrongful trading. This applies for any period of wrongful trading between 1 March and 30 September 2020. The provision has now lapsed and there has been no extension of the relaxation of wrongful trading provisions.

All of the directors' legal duties outlined in this note remain in place, and administrators and liquidators will retain the ability to seek to hold directors to account, where breaches of these duties have occurred.

Directors of companies which end up in administration or liquidation, who have acted in breach of their duties, also face the risk of action being taken to disqualify them from acting as company directors for up to 15 years, together with the potential of a compensation order being made against any individuals disqualified.

Do the directors each understand their role, responsibilities and duties?

If a company enters a formal insolvency process, the actions of its board and the individual directors will always be considered and scrutinised with the benefit of hindsight.

Each of the directors needs to understand the extent of their duties and how these duties change when the company's solvency is in question.

The cumulative impact of Covid-19, Brexit, and the economic uncertainty in 2022 have brought unprecedented challenges to boards. To discharge their legal duties, directors are expected to use their skill and judgment as well as their experience of the businesses and markets within which they operate.

Is there a turnaround plan in place?

Simply monitoring a company's financial position is not enough. Directors must give priority to devising and implementing a strategy for restoring the company to a stable and profitable position.

This is made very difficult by the constantly changing and unpredictable economic environment.

Is the board holding regular meetings?

Board members must remain in close contact and should speak regularly to enable informed decisions to be made about future steps. With the speed of movement in current events, this might be at least weekly, with informal discussions taking place more regularly in between.

Is there an audit trail?

Any liquidator or administrator will be obliged to review the actions of the directors in the period leading up to the formal insolvency process. A complete audit trail of the decisions and reasons for those decisions may provide vital evidence that the directors have acted fully in accordance with their duties and responsibilities.

As a result, all board decisions should be carefully documented.

Should the board keep key creditors informed?

Directors must not mislead creditors about the company's financial position when incurring credit.

However, directors often face the conundrum of whether to inform certain key creditors in order to obtain their support for a turnaround but, in so doing, may risk individual action being taken which jeopardises the chances of success. The right approach will depend on the circumstances.

In many cases, particularly with sophisticated lenders, there may be no choice for the board but to engage. The company will often be under a contractual obligation to inform the lender of insolvency and any other material risks and events and, in many cases, the turnaround plan may be incapable of delivery without informed lender support.

A company's underperformance may – and its insolvency almost certainly will – trigger defaults in its finance documentation. Breach of a covenant may entitle a lender to make demand for immediate repayment. Where a breach has occurred, or it is anticipated that a breach may occur, it is important to contact the lender(s) and, where possible, negotiate a formal waiver.

How should customer deposits be treated?

Customer deposits should not be taken where the directors know (or ought reasonably to know) that the orders will not be fulfilled. Whether customers who pay by credit card may have other rights to recover deposits does not change that position.

As a minimum, where solvency is an issue, customer deposits should be paid into a separately identifiable account and not used as working capital. It may be possible to create a trust account to protect the deposits in the event of insolvency but this is not straightforward and the agreement of the company's lenders may be needed.

Are other creditors and key stakeholders being kept informed?

The company's external stakeholders are likely to include any institutional lender and HMRC. There may be other parties whose support is needed for the implementation of the company's turnaround strategy, for example, the trustees of a defined benefit pension scheme, or an overseas parent.

Key stakeholders must be kept informed of the progress of the turnaround strategy. The company's financial and legal advisers will be able to assist with this.

Is there a directors' and officers' insurance policy in place?

The terms of any insurance policy should be reviewed to ascertain the scope of the cover. Certain board actions may trigger a need to notify the insurers, and notifications should be made where required.

Should the directors resign?

Although the board of directors should act collectively, the threat of insolvency is a highly stressful situation and may lead to disagreements. It is particularly important to ensure that all discussions, however challenging, are carefully documented.

Sometimes it may be appropriate for a dissenting director to resign in protest against the board's collective decision. However, this will not relieve the departing director from liability for wrongful acts or omissions which took place during their term of office.

Directors who do resign may also be criticised for abrogating their duties and responsibilities at the very time when the company's creditors and other stakeholders need them most.

Do	Don't
• Take every step with a view to protecting creditors' interests – it is the duty of directors of insolvent companies to do so above all else	• Trust to blind faith or ignore the problem in the hope that it will go away
• Plan and act early	• Trade on at the expense of creditors beyond the point of no return
• Hold regular board meetings and communicate frequently	• Mislead creditors or take credit without a reasonable expectation of it being repaid
• Share information and voice any concerns to the board	• Make payments/grant security without reasonable expectation of benefit to the company
• Take insolvency advice from suitably qualified lawyers and accountants	• Put personal or other interests ahead of those of the company
• Check D&O insurance policy triggers and notification requirements	• Just resign without first exploring all available avenues to deliver the best outcome for creditors
• Investigate, formulate, adopt and maintain a viable strategy in response	• Assume that Covid-19 will mean that breaches of duty will be ignored
• Plan for contingencies, including formal insolvency	• Keep key stakeholders in the dark

Contact us

Please contact us using the details below and we would be happy to set-up a video conference/call with you or your wider team.

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