Companies in Financial Difficulty

A Guide for Directors

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SOLICITORS

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Introduction

The effects of the global economic crisis are being felt by almost all commercial businesses, but a company may find itself in financial difficulty for any number of reasons. A company's trading activities may have been following a reducing trend for some time or it may find itself in difficulty almost overnight, perhaps because of the loss of a significant customer or supplier.

A squeeze on cash flow can be seen as a short term problem that will right itself with some hard work and a bit of luck. However, struggling on without any real prospect of longer term success is rarely beneficial for the company, its creditors or employees.

Legislation in this area is aimed at developing a rescue culture and to that end, directors are encouraged to acknowledge difficulties early on and seek advice as soon as possible while greater scope for recovery remains available.

How soon should you seek advice and what are your duties and responsibilities as a director in the event your company is facing financial difficulties?

This note considers the duties of directors of single, private companies only. Directors of public companies and group undertakings have additional responsibilities and reporting requirements.

When is a company insolvent?

There are two alternative tests to determine insolvency.

The traditional view is the ***cash flow test***: a company is solvent if it can pay its debts as they fall due, no matter what its balance sheet looks like.

This test has been supplemented by the ***balance sheet test***: a company that can pay its debts may still be insolvent if, broadly stated, according to its balance sheet, liabilities (including contingent liabilities) exceed assets.

It is important to establish when a company may be insolvent for a number of reasons. For example:

- Directors owe certain, specific duties once a company becomes insolvent

- Insolvency is a pre-requisite for the instigation of formal insolvency proceedings

- If a company is insolvent when it enters into certain types of transaction and formal insolvency proceedings are commenced within a specified time, the transaction may be open to challenge

- Whether a company is solvent or not will determine if a voluntary liquidation is controlled by the members or creditors

- Certain company law procedures may only be taken by solvent companies

Steps for the Board to take

Be Informed

First, if the directors are to make informed decisions about the trading position and prospects of the company, it is essential that the board has all the information available to it to carefully monitor the trading and financial position of the company. Clearly, this information must be comprehensive and regularly updated in order for it to be useful in the context of a company facing financial difficulties.

Does the information show that the company is insolvent under the ***Cash Flow Test*** and/or the ***Balance Sheet Test***?

Take Advice

If the board is at all concerned about the financial stability of the company, it should seek external advice from a recovery specialist without delay.

Stay Informed

The directors must ensure that the trading and financial position of the company is closely monitored, and regular updates are presented to the board for consideration, until either:

- A specific course of action becomes necessary, or
- The company is no longer in financial difficulty

What to look out for

The key point for the board is to be satisfied that if the company continues to trade, given the trading and financial information available to it, ***is there at least a reasonable prospect that the company will avoid insolvent liquidation***? Can the company pay all its creditors and survive as a viable business and as a going concern based on the information available?

If the board is unable to conclude that there is at least a reasonable prospect of the company avoiding insolvent liquidation after careful consideration of all the information available to it, the directors must take every step to minimise potential loss to creditors.

If the board concludes that the company has negative assets (i.e. it fails the ***Balance Sheet Test***) but that it is able to pay its creditors as they fall due, whether out of existing cash flow or from new capital (i.e. it passes the ***Cash Flow Test***), it may be reasonable for the company to continue trading, but the prospects of the company avoiding insolvent liquidation must be kept under constant and careful review.

Keep Records

Whenever the company's solvency is discussed at board level a clear, concise and unambiguous record of the matters discussed, the information supplied and relied upon, advice taken and the thinking and reasoning behind decisions reached including, in particular, any decision to continue trading should be maintained.

If the board concludes that the company cannot continue?

The directors must act appropriately when considering a company's ability to trade and, if they do not, personal liability may follow.

So, first, who are the 'directors'?

- Anyone appointed as a director in accordance with the company's articles of association (whether or not this has been registered at Companies House)
- Anyone who is actively involved in management level decision making of a kind generally undertaken by the board of directors, even if he has not formally been appointed as a director

• It may be possible for someone who is 'held out as a director' to be considered a director for these purposes, notwithstanding that he has not been formally appointed as a director. For example, someone commonly referred to as 'Sales Director' and where this title is used in external communications. However, this is less likely where there is a board of directors making decisions and where the individual is not invited/entitled to participate

• Shadow Directors: someone "in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity)"

Personal Liability of Directors

The general principle that directors are not personally liable for the debts of a company may be set aside in an insolvency situation in certain circumstances. For example:

• ***Personal guarantees***: It is common for directors of private companies to guarantee certain liabilities of the company (particularly in the case of owner-managed businesses). In difficult times, directors must be fully aware of their rights and obligations under any personal guarantees

• ***Wrongful trading***: A director may be personally liable for the debts of a company if he allowed the company to continue to trade at any time when he knew (or ought to have concluded) that there was no reasonable prospect of the company avoiding insolvent liquidation. Only the liquidator of the company can bring an action for wrongful trading. In deciding whether a director has been guilty of wrongful trading, the Court will apply the standard of a 'reasonably diligent person' and consider:

(a) the general knowledge, skill and experience which may be reasonably expected of a person entrusted with carrying out the same functions as are carried out by that director, and

(b) the general knowledge, skill and experience which that director actually has.

Each director is judged as an individual and accordingly, higher standards may apply to some than to others sitting on the same board of directors. However, note that all directors have a collective responsibility to ensure that the company is a viable trading entity and this responsibility cannot simply be left to one or two individuals.

The Court will not find a director liable for wrongful trading if, once he knew (or ought to have concluded) that there was no reasonable prospect of the company avoiding insolvent liquidation, he took every step which he ought to have taken to minimise potential loss to creditors.

If a director is found guilty of wrongful trading, the amount he may be obliged to

contribute is likely to be assessed on the amount by which the company's losses increased after he ought to have taken steps to minimise them, but did not.

• ***Fraudulent trading***: If it becomes apparent that the company's business has been carried on with intent to defraud its creditors, a director may be required to contribute towards the liquidation fund (as with wrongful trading). There is a required element of dishonesty here and directors found guilty of fraudulent trading may be subject to criminal proceedings and, in serious cases, even sent to prison.

• ***Misfeasance or breach of duty***: A liquidator may apply to Court to compel a director to account for any money or assets which may have been 'misapplied'. Similarly a director may be required to compensate the company in the event of any misfeasance or breach of duty. A number of statutory director's duties have been introduced under the Companies Act 2006 (which was largely an attempt to codify the existing common law). One such duty is that a director must exercise his duties in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole.

However, where the company's financial position has worsened so that it may be unable to pay its creditors, the directors must exercise their duties in the interests of the company's creditors.

• ***Disqualification***: The Secretary of State for BERR may apply for a disqualification order against any director of a company that has gone into liquidation, administration or receivership whose conduct suggests that he is "unfit to be concerned in the management of a company".

When considering a disqualification order, the Court will consider, among other things, the following:

• Whether there is any suggestion of misfeasance or breach of duty

• Whether any property of the company has been misapplied by the director

• Whether a director has attempted to shelter company assets from creditors

• The extent of the director's responsibility for the company becoming insolvent

• The extent to which the director is responsible for any failing by the company in meeting its statutory duties in respect of record keeping (for example, the maintenance and retention of accounting records)

• Whether there is any suggestion of a failure to co-operate with the insolvency practitioner appointed to manage the affairs of the company

As an alternative to disqualification, a director may be required to enter into binding undertakings which might be less public but which will have a similar effect to a disqualification order.

Criminal Liability of Directors

As well as criminal sanctions for fraudulent trading, directors (past or present) may be prosecuted and, if found guilty, fined or even sent to prison where their conduct is considered particularly inappropriate. Some examples of such conduct include:

• concealing or fraudulently sheltering property belonging to the company (with a value of £500 or more)

• falsifying, destroying or concealing company records

• disposing or pledging property acquired by the company on credit, other than in the ordinary course of business

• refusing or failing to provide the insolvency practitioner appointed by the company with records or property belonging to the company (if requested to do so)

• being involved in the formation or management of a business with a name similar to the name used by an insolvent business, where the director was a director of the insolvent company at any time during the twelve months prior to the insolvent liquidation, at any time during the twelve months following the insolvent liquidation (a director, if found guilty, may also be held liable for debts incurred by the new company while trading under the prohibited name)

<u>Transactions that may be vulnerable to challenge</u>

The legislation contains provisions which seek to prevent steps being taken ahead of liquidation that are, or may have the result of, reducing the assets of the company available to the creditors on a winding up of the company.

• ***<u>Transactions at an undervalue</u>***: If a company enters into a transaction at any time it is unable to pay its debts (or if it becomes unable to pay its debts because of the transaction) and if, within the relevant period (from six months to two years depending on the identity of the other party to the transaction), specified steps leading to the appointment of an administrator are taken or a petition resulting in the insolvent winding up of the company is presented, that transaction may be set aside if it was made at an undervalue.

That is to say, if it is:

• a gift, or otherwise provides no consideration to the company, or

• a transaction for a consideration which, in money or money's worth, is significantly less than, in money or money's worth, the consideration provided by the company

A transaction will not be set aside if it was entered into in good faith and for the purpose of carrying on the business of the company, and if the Court is satisfied that at the time there were reasonable grounds for believing that it was being made for the benefit of the company.

The Court has a very wide discretion and may make any order it sees fit to restore the position of the company. The Court may, for example, order the return of the property to the company or order that a proper price be paid under the transaction (if the return of the property is no longer possible).

• ***<u>Transactions defrauding creditors</u>***: The insolvency practitioner appointed by the company or (if there is no insolvency practitioner appointed) any person prejudiced by such a transaction, may apply to the Court to have the position of the company restored to what it would have been had the transaction not been entered into. There is no requirement to prove dishonesty, but it must be shown that:

• the company entered into a transaction at an undervalue, and

• the company did so in order to place assets beyond the reach of its creditors or took action that would otherwise prejudice their interests

- ***Preferences***: If a company does anything that would, if the company were to go into insolvent liquidation, enhance the position of any creditor, surety or guarantor beyond that which it would have been in had the company not taken such action, and it can be shown that the company was "influenced by a desire" to improve the creditor's, surety's or guarantor's position on insolvency, then the Court may order that the transaction be set aside.

Practical Steps

In the current climate, generally:

- ***Review existing facility agreements and guarantees***: If a company is in danger of breaching its borrowing covenants, it may seek to renegotiate those terms to avoid a breach. Renegotiation of covenants is more likely to be successful in the current market than a refinancing. A general review of banking arrangements should be undertaken and particular attention should be given to penalty provisions in the event of a breach of covenant. In particularly severe circumstances, it may be possible to agree a workout with lenders

- ***Re-evaluate budgets and business plans***: Testing strategy and targets against management reports will help pinpoint weakness and highlight successes

- ***Monitor financial position***: Assess liquidity for short and medium term and take action as required

- ***Review commercial agreements***: Assess and monitor the company's exposure to the liquidity of its customers and suppliers. Avoid liquidity exposure on customers and have a 'Plan B' for suppliers

- ***Review corporate governance procedures***: Hold regular board meetings and monitor trading and financial performance closely. Prepare and maintain detailed records of all deliberations and decisions of the board

- ***Consider incentivising management***: While it may be counter-intuitive to rebase the strike-price of options, it may be appropriate to reconsider what constitutes success in light of external forces

In the event of financial difficulty:

Does the company meet the criteria for insolvency set out in the:

- ***Cash Flow Test*** and/or

- ***Balance Sheet Test***

Always:

- ***Be informed***

- ***Take advice***

- ***Stay informed***

- ***Keep records***

- ***Exercise sound judgement***

Notes:

This guide is intended to provide a brief summary and general overview of certain aspects of the legislation in relation to corporate insolvency which may be of particular interest to company directors in the current economic climate. It does not purport to be comprehensive and accordingly, you should not seek to rely on this guide as providing specific legal advice in any particular circumstance.

Specific, specialist advice should be sought at the earliest opportunity if you consider that your business may be in financial difficulty.

For more information, or to discuss any particular circumstances, please contact:

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