JAMESCOWPER KRESTON

Accountants & Business Advisers

Guide to the responsibilities of the directors of an insolvent company

1. Who is a director?

We generally think of directors as people who are on the board of directors and registered at Companies House, however, in insolvency proceedings others might be considered as directors such as shadow and de-facto directors.

Shadow director
A shadow director is a person who, without being formally appointed, gives instructions or directions on which the directors of a company are accustomed to act. There are a number of circumstances in which you might come across a shadow director. One of the more common is where a bankrupt, who by reason of his bankruptcy cannot act as a director, persuades someone else to be formally appointed but he or she then acts in accordance with the bankrupt's wishes.

De-facto director
A de-facto director is a person who, without being formally appointed, performs the managerial functions of a director of the company. An example of this might be where a director, who has resigned his directorship for whatever reason, continues making decisions as if he were still a director.

Non executive director
Under statute the responsibilities and duties of non-executive directors are the same as other directors. When considering a directors' conduct however, the courts are likely to have regard to both the individual's status and his or her role.

2. What responsibilities do directors have?

Directors are responsible for the management of their companies. They must act in a way most likely to promote the success of the business and benefit its shareholders. They also have responsibilities to the company's employees, its trading partners and the state. Directors are given wide powers to help promote the company. However directors face serious penalties if they abuse those powers, or use them irresponsibly.

When a company is facing financial uncertainty, the directors' focus should change from returns to shareholders wealth to protecting creditors' interests. This not only affords the best protection to creditors but should also reduce potential personal risks to directors.

3. How do directors protect creditors and limit their personal exposure?

When a director becomes aware that the company is in financial difficulties the responsible course will generally be to take professional advice, initially this may be from the company's accountant or solicitor. It may be considered necessary to consult an insolvency practitioner.

The insolvency practitioner normally considers and advises on:

- The current financial position to determine the solvency, or otherwise of the company
- Whether continued trading is advisable
- Whether additional finance is required and, if so, the source of that finance
- Assuming that continued trading is appropriate, the production of forecasts and subsequent review of performance against those forecasts at regular intervals
- The holding of regular board meetings to review financial performance so that any deterioration can be identified and appropriate action taken. Directors are generally advised to minute those meetings carefully
- How creditors are to be paid and when
- What should be done with customer deposits received in the normal course of business
- How to maintain continuity of supply of stocks and other goods / services
- Other specific advice relating to the company

At James Cowper we are able to work with directors and their advisors to produce an easy to follow 'traffic light' warning system to guide directors. Taking advice early could help avoid a formal insolvency procedure and reduce the risk to directors personally.

4. What does an insolvency practitioner do in relation to directors' conduct?

Any discussions or meeting that you might have with us in the lead up to any formal insolvency are confidential.

If the company cannot avoid insolvency and an insolvency practitioner (IP) is appointed, however, the IP is required to:

- Undertake an investigation into the conduct of all directors that have held office in the three years prior to the insolvency and report his or her findings to the Insolvency Service. The Insolvency Service takes such a report into consideration when deciding whether it is appropriate to seek a director's disqualification
- Establish whether it is appropriate to bring action against the directors, officers or others to recover monies for the benefit of creditors

If in the course of the IP's work issues of a money laundering nature come to light then the IP has a duty to report such activities to the relevant authorities.

That said, if directors have acted responsibly they should have nothing to fear from the IP's performance of these statutory duties.

The Insolvency Service is an agency of the Department for Business Energy and Industrial Strategy charged with overseeing insolvency and related issues such as a directors' misconduct.

5. What could result in potential personal liability of the director?

There are a number of specific areas where there could be consequences for directors, officers and others which could result in a personal financial liability.

Misfeasance and breach of duty
An often overlooked, but overriding, point to bear in mind is that a director of a company owes it a duty of care to put the company's interest ahead of his own. In practice, this can give rise to significant conflicts of interest perhaps most obviously where an individual is a director of several companies involved in dealings with one another such as might arise within a Group. Where the companies are solvent this conflict can be easily overcome by each of the companies, in effect, implicitly waiving the obligation imposed on the director.

The difficulties that can arise with such a waiver can only be effective where each concerned remains solvent. Where one or more companies become insolvent, however, any breach of duty has the potential to affect the returns to creditors. In a company which is, or may be about to become, insolvent therefore directors should take particular care to ensure that the company's interests are placed ahead of their own and that, in all circumstances, they act in a respectable manner.

Wrongful trading
The Court can hold a director personally liable where it is satisfied that he or she continued the company's activities, giving rise to losses for creditors, when he or she knew or ought to have concluded that the company had no reasonable prospect of avoiding liquidation. A defence to such an action is, however, to show that the director took every step that he or she ought to have taken to minimise losses to creditors.

Whilst this might sound alarming, there are several points to bear in mind as follows:

In the past, liquidators have only pursued wrongful trading actions through to judgment in a very small number of cases. This is because the Courts have not been eager to find against directors and the related costs of a wrongful trading action can prove prohibitive.

The test is that there has to have been no reasonable prospect that the company could avoid liquidation. The key here is whether the directors are continuing recklessly, incurring credit which can never be paid and worsening an already irretrievable position for creditors.

Fraudulent trading
It is very rare for an insolvency practitioner to bring an action for fraudulent trading. But if, in the course of a winding up, it appears that business had been carried on with the intent to defraud creditors or for any fraudulent purpose the Court may require culpable persons to make contributions to the company's assets.

Transactions at an undervalue / preferences
The insolvency legislation contains provisions to reverse transactions motivated by a desire to give one creditor preferential treatment. That is not to say that a struggling company cannot pay a creditor which is placing the company under duress for payment or whose services are critical for some reason.

The key here is a desire, probably unprompted, on the part of the directors to take greater care for the interest of one creditor in the face of an impending insolvency. Typically such circumstances arise when the evidence suggests that there has been a marked reduction in sums due to a creditor holding little or no security from the company but whose debt is covered by a director's personal guarantee. Another common example arises where the company settles a debt to someone connected with the company (such as a director who has a loan to the company) when there has been no pressure for settlement.

Likewise, the directors of a troubled company should not dispose of assets, particularly to connected parties such as themselves or their family members, for less than full value. Such transactions could be deemed transactions at an undervalue and may be overturned in a subsequent liquidation. Whilst not necessarily affecting the directors' personal finances, transactions could still be grounds for the bringing of disqualification proceedings.

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6. Further assistance

If you would like to discuss any aspect of this guide and how it might affect you please contact one of our team on the contact details above.

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