SQUIRE PATTON BOGGS

Directors' Duties – England & Wales

Considerations for Directors When a Company Is in Financial Difficulty

This quick guide summarises the duties that directors of companies incorporated in England and Wales are subject to, and how those duties change when the company is insolvent or at risk of being insolvent. It also provides an overview of the personal risk to directors when the company is in financial difficulty.

This note is intended as an overview and should not be relied on as legal advice. Should you require legal advice in relation to your specific circumstances, please contact the Restructuring & Insolvency team members whose contact details are at the end of this note.

Directors' Duties When Solvent

- Each director owes individual duties to the company to promote the success of the company for the benefit of its shareholders as a whole.
- Statutory duties require that directors also take into account wider factors such as the environment, employees, the standard of their business conduct, business relationships with suppliers and customers, and any other relevant circumstances.
- Directors' duties must be exercised in good faith.
- A breach of any of the statutory duties is actionable by the company, and any right of action could be exercised by an appointed insolvency practitioner should the company later enter a formal insolvency process.

Directors' Duties When Insolvent, or at Risk of Being Insolvent

- The focus of directors' duties shifts at the point where the directors can no longer be confident that the company will remain solvent.
- Solvency is tested on either a cash flow basis (i.e. ability to pay creditors within terms) or balance sheet basis (i.e. assets exceeding liabilities).
- Directors' duties switch to a requirement to take decisions for the benefit of the company's creditors as a whole.
- The duty owed to shareholders will be secondary; whilst the interests of shareholders remain relevant during any period in which the company is, or may be, insolvent, the directors should not be influenced by any power any individual shareholder has to remove or replace the directors (or any of them) and must act in what they consider to be in the best interests of the company's creditors.

It is important for directors to understand their directors' duties, as well as how their actions and the decisions the board makes when the company is in financial distress could expose them to personal liability, criminal sanction and risk.

The following is an overview of the potential claims and potential exposure for directors if the company is insolvent or at risk of insolvency.

Wrongful Trading

Directors may be liable for wrongful trading if they continue trading a company where they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Although, if the directors can show that they took every step possible to minimise creditors suffering additional losses during that continued trading, they may have a defence to the claim.

The UK government has passed the Corporate Insolvency & Governance Act 2020 that temporarily amends the UK Insolvency Laws on wrongful trading for at least the period from 1 March 2020 to 30 September 2020. The legislation makes no distinction between those businesses that are affected by COVID-19 and those that are not. However, certain companies such as building societies and banks are excluded. The changes made by the legislation mean that the courts will assume that a director is not responsible for any worsening of the financial period of the company or its creditors during this six month period, however this does leave open the possibility that such an assumption may be capable of being rebutted. Given that the legislation only amends the wrongful trading regime temporarily and directors' actions can still be challenged on grounds of misfeasance, directors should continue to follow best practice in any event (see below).

Mismanagement Errors

A director could also be ordered to make contributions to the company's assets if the director knowingly carries on the business of the company with intent to defraud creditors.

Liability for Antecedent Transactions

- **Preference** – Directors could face personal liability for loss to creditors if they enter into a transaction that places a creditor in a better position than they otherwise would have been in an insolvent liquidation (if that preference had not occurred) (e.g. repaying debt due to a connected entity, ahead of other creditors). The "lookback" period is either six months or two years prior to the onset of insolvency, depending on the circumstances of the transaction.
- **Transaction at an undervalue** – Directors may be ordered to compensate the company and its creditors for any losses suffered as a result of the company entering into a transaction at an undervalue. A transaction at an undervalue is one where the company either gifts an asset to a third party or receives less than reasonable market value for it. The "lookback" period is two years prior to the onset of insolvency.
- **Transactions defrauding creditors** – Directors may be ordered to compensate the company and its creditors for any losses suffered as a result of assets transferred from the company at an undervalue, with the intention to put those assets beyond the reach of creditors. There is no "lookback" period for such transactions

Personal Guarantees

Directors should be aware that if they have given personal guarantees, they may be personally liable for the company's debts under them. Repaying creditors to discharge a debt that a director has personally guaranteed may also constitute a preference.

Liability for National Insurance Contributions (NIC)

- If a company does not pay the correct amount of NIC, HM Revenue and Customs (HMRC) has the ability to recover the unpaid NIC plus interest and penalties from the directors if the failure to pay was due to fraud or neglect.
- Circumstances where HMRC may investigate and use its powers may include persistent failures to pay NIC, whilst at the same time the company made significant and/or regular payments to other creditors, connected persons or companies, or in the form of directors' salaries.

Liability for Misfeasance

Directors may be required to compensate the company for losses caused as a result of breaches of their duties. A breach arises if a director fails to exercise reasonable care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions of that director, and the actual experience of that director.

Repayment of Dividends

A dividend may be unlawful to the extent that the dividend is in excess of available distributable profits. A director who authorises the payment of an unlawful dividend may be acting in breach of their duties and may be personally liable to repay the company, even if the director is not a shareholder. Dividends may also be challengeable as transactions at an undervalue (see above).

Director Disqualification

Directors can be disqualified from acting for between two and four years. Insolvency practitioners have a duty to report to the Secretary of State on the conduct of each of the directors of an insolvent company, and the Secretary of State may bring disqualification proceedings if the directors' conduct is thought to be unfit.

Criminal Liability/Liability for Company Debts

Directors should be aware that it is an offence for a director or shadow director of a liquidated company to be involved either directly or indirectly with a new company with a similar name to the liquidated company for a period of five years beginning with the day on which the company went into liquidation. If a director breaches this provision, the penalties include imprisonment, a fine or both, together with personal liability for the debts of the new company. A director is at risk when buying back the business and assets of an insolvent company unless certain steps are taken to avoid that.

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See our Summary of European Government Financial Support Guide to find out what financial support European governments are offering to help support businesses

For further information and to receive updates relating to the legal impact of COVID-19 please sign up to our COVID-19 Resource Hub.

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Practical Tips to Mitigate Liability

- Directors should consider appointing restructuring legal (and possibly accounting) advisers to support the company where they believe there may be a risk of insolvency.
- Board meetings should be convened regularly (possibly weekly), financial performance should be closely monitored and decisions clearly documented.
- The board should consider whether the company continues to operate within its existing finance facilities and should carefully scrutinise any extension of facilities or additional credit (with support from the advisers).
- Contingency plans should be created and discussed with advisers.
- The board should not enter into any transactions at an undervalue unless the board believes in good faith that the transaction would benefit the company (and in which case, the basis of that belief should be fully documented).
- The board should not take any action with the intention of putting a creditor in a preferential position, unless absolutely necessary due to creditor duress (in which case, the rationale should be fully documented).

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