

ALLEN & OVERY

# Restructuring Across Borders

## England and Wales:

The position of directors of companies  
in financial difficulty | October 2020





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# General

There are four main areas of concern for directors of companies in financial difficulty:

- wrongful trading;
- disqualification as a director for being “unfit”; and
- fraudulent trading;
- duty to consider creditors’ interests where the company is, or is likely to become, “insolvent”.

## Directors, de facto directors, and shadow directors

As a preliminary point it should be noted that in relation to wrongful trading and disqualification, the term “director” has an extended meaning. It includes not only directors properly so called (including “de facto” directors), but also “shadow” directors. The statutory definition of a shadow director is:

“a person 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)” (section 251 Insolvency Act 1986).

The intention is to cover those who, although not formally appointed to the board, regularly give directions or instructions to the directors such that they exercise a real influence on the affairs of the company. It may also cover parent companies

(that is, a parent company may be the shadow director of a subsidiary) where the parent or the directors of the parent operate a “hands on” approach to running the group and interfere consistently in the management of the subsidiaries.

A de facto director is someone who has not been formally or validly appointed as a director of a company but who carries out directorial acts and so will be held for certain purposes to be a director. The cumulative effect of the director’s activity is relevant and the issue has to be looked at ‘in the round’. It is a question of fact and degree. The director will be someone who has real influence on company affairs (and in that sense, this director’s impact will resemble that of shadow directors).

By contrast, the fraudulent trading regime applies to “any persons who were knowingly parties to” the fraudulent trading.



# Wrongful trading

**Please note:** in response to the Covid-19 pandemic, the UK Parliament passed the Corporate Insolvency and Governance Act 2020 (CIGA). The CIGA contains a ‘suspension’ of the wrongful trading law described below in respect of acts or omissions by directors or shadow directors in the period from 1 March 2020 until 30 September 2020. The Secretary of State may by Regulation extend the expiry date (sections 39(1) and 39(2)(a) CIGA). While the provisions came to an end on the 30 September 2020, under secondary regulations, a further suspension of wrongful trading came into force on 26 November 2020, and will expire on 30 April 2021. The ‘suspension’ provides that the court is to assume the company’s directors are not responsible for any worsening of the financial position of the company or its creditors that occurs during the relevant period, that is, the dates between 1 March 2020 and 30 September 2020, and between 26 November 2020 and 30 April 2021. As a result of the second suspension only coming into force on 26 November 2020, there is a short period between 1 October 2020 and 25 November 2020 where the wrongful trading regime will apply with full force and directors may be considered responsible for any worsening of the financial position of the company or its creditors during this period in the context of any contribution to the assets of the company they are directed to make under the wrongful trading provisions. The ‘suspension’ does not apply to a number of different types of company, including banks/investment banks, insurance companies, securitisation companies, and companies who have issued certain types of capital market instruments (for the full list of excluded companies, see section 10(3) and (4) and Schedule 1 CIGA; the latter gives details of a new Schedule ZA1 to the Insolvency Act 1986).<sup>1</sup>

Wrongful trading is designed to make directors liable in certain circumstances for debts and liabilities of the company of which they are officers.<sup>2</sup> It effectively places an onus on the directors, on becoming aware (or when they *should be aware*) that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration, to take every step with a view to minimising the potential loss to the company’s creditors.

The aim is not to overload the directors with pressure in the already difficult circumstances of their company being in financial difficulty, but to ensure directors focus their minds during this time on the impact their actions and decisions may have on creditors.

The provisions apply in an insolvent liquidation and an insolvent administration. “Insolvent” for these purposes means that the assets of the company are insufficient to meet all liabilities and the costs and expenses of the winding-up/administration (ie a balance sheet test).

The court, on the application of a liquidator/administrator (or an assignee of such right of action)<sup>3</sup>, may declare that a person who is or has been a director of the company is liable to make such contribution to the company’s assets as the court thinks proper where:

- the relevant company has gone into insolvent liquidation/administration;
- at some point prior to the start of the liquidation/administration, that person knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation/administration; and
- from the moment described above, that person failed to take every step they ought to have taken with a view to minimising the potential loss to the company’s creditors.

The minimum standard required of a director is that of a reasonably diligent person having the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as that director. However, the actual standard by which a particular director is judged may be materially higher if that director’s general knowledge, skill and experience are, in fact, much greater than might reasonably be expected. The standard is thus composed of objective and subjective elements. This combined standard is used to assess when the director should have concluded that insolvent liquidation/administration was unavoidable and also the steps the director should have taken to minimise losses to creditors.

<sup>1</sup> For a detailed overview of the measures introduced by the CIGA, please see our detailed bulletin (set out in an easy to use Q&A format) available [here](#).

<sup>2</sup> The liability to contribute to the assets of the company is intended to be primarily compensatory and not penal in nature and, therefore, the starting point for quantifying the amount of any contribution by directors is to identify the increase in the net deficiency during the period under review.

<sup>3</sup> A liquidator and an administrator each has the statutory power to assign a right of action for wrongful trading and/or fraudulent trading and it is possible therefore that a director could find an action for wrongful trading and/or fraudulent trading brought against them by a party other than the liquidator or administrator of the company.



The assessment of whether a director should have concluded insolvent liquidation/administration was unavoidable will not depend upon a snapshot of the company's financial position at any given time, but on rational expectations of what the future might hold.

However, a director is not expected to be clairvoyant and the fact that he or she may fail to see what eventually comes to pass does not necessarily mean that he or she will be liable for wrongful trading.

The court will not make an order for wrongful trading if a director, knowing (based on the objective and subjective tests above) that there was no reasonable prospect of the company avoiding going into insolvent administration or liquidation, took **every step** with a view to minimising the potential loss to the company's creditors as he or she ought to have taken.

What these steps are in any particular case will depend on the circumstances and the combined test referred to above. In some circumstances, it will mean ceasing to trade and/or seeking to place the company into insolvency proceedings immediately; in others, it might be appropriate for the directors to continue trading with a view to trading out of insolvency<sup>3</sup> or achieving a better result for creditors overall than would otherwise be the case. However, the courts have made it clear that this defence of directors' conduct is not available if an individual creditor is made worse off even if the position of the general body of creditors improves. Peter cannot be robbed in order to pay Paul and others.

The courts have recognised the difficult position of directors in these circumstances where they may face criticism whichever course they pursue – “if directors close down immediately... although they are not at risk of being sued for wrongful trading, they are at risk of being criticised on other grounds”<sup>4</sup> given the greater likelihood of any resulting liquidation being insolvent, the costs of liquidating a company and the avoidance tactics debtors will try to employ to avoid paying the insolvent company. Trading on may be the most reasonable course where the company has incurred most of the upcoming costs for running the business and reasonably anticipates that profits will soon be forthcoming<sup>5</sup>.

Dishonesty is not an element of wrongful trading and the absence of that element will often make wrongful trading easier to prove than fraudulent trading (see next section).

It is likely that the wrongful trading provisions will be regarded as having extra-territorial effect and so will not just apply to directors (or shadow directors) based in the UK<sup>6</sup>.

A director found to be liable for wrongful trading and who is required to contribute to the assets of the company may also have a disqualification order made against him or her (see further below).

<sup>4</sup> Re Continental Assurance Company of London plc [2007] 2 B.C.L.C. 287.

<sup>5</sup> In the matter of Marini Limited [2003] WL 1823004.

<sup>6</sup> It was assumed that the wrongful trading provisions had extra-territorial effect in Re Howard Holdings Inc [1998] BCC 549. The Supreme Court in Bilta (UK) Ltd (in liquidation) v Nazir [2015] UKSC 23 held that the fraudulent trading provisions had extra-territorial effect.

# Fraudulent trading

Fraudulent trading may apply if, in the course of a liquidation/administration of a company, it appears that any business of the company has been carried on with the intent to defraud creditors of the company (or creditors of any other person) or for any fraudulent purpose.

The court, on the application of a liquidator or administrator (or an assignee of such right of action), may declare that any person who was knowingly party to the carrying-on of the business in this manner (including, for example, the directors) is liable to make such contribution (if any) to the company's assets as the court thinks proper<sup>7</sup>. This will require the court to consider whether the person concerned: (a) participated in the carrying on of the fraudulent business; and (b) did so knowingly ie where he or she was participating with knowledge that the conduct was intended to defraud. Knowledge will extend to deliberately shutting one's eyes to the obvious.

Fraudulent trading carries both criminal and civil liability, with a maximum sentence of ten years imprisonment. Actual dishonesty in the running of the company is an essential element of the offence. It is not enough to show that the company continued to run up debts when the directors knew that there was no prospect of avoiding insolvency; there must have been actual dishonesty involving real moral blame (although note that fraudulent trading may be proved where debts are dishonestly incurred by directors on behalf of a company where the directors know there is little prospect of the debts ever being paid in full). Wrongful trading was introduced by legislation because fraudulent trading was, and is, difficult to prove.

As mentioned above, the Supreme Court has held that the fraudulent trading provisions have extra-territorial effect and so will apply not just to directors (or shadow directors) based in the UK<sup>8</sup>.

A director found liable for fraudulent trading may also have a disqualification order made against him or her (see further below).

<sup>7</sup> Contributions need not be the same for each person involved. So, although contributions may be ordered on a joint and several basis for the full loss caused to creditors, the court can also make a separate assessment of the contribution required by each person: *Re Overnight Ltd* [2010] EWHC61 3 (Ch). The contribution should not include a punitive element.

<sup>8</sup> *Bilta UK Ltd (in liquidation) v Nazir* [2015] UKSC 23.



# Disqualification and compensation orders

The court will make a disqualification order (of between 2 and 15 years) against a particular person where it is satisfied that:

- the person is or was a director or shadow director of the company which has become insolvent during or after the time the person was a director (or shadow director); and
- the conduct of the person as a director is such that the person is unfit to be concerned in the management of a company.

For these purposes, a company “becomes insolvent” in one of three ways:

- if it goes into liquidation at a time when its assets are insufficient for payment of its debts and liabilities, and the expenses of the winding-up;
- if a company enters administration; or
- if a company has an administrative receiver<sup>9</sup> appointed to it.

The liquidator, administrative receiver, administrator or official receiver has a duty to send the Secretary of State for Business, Energy and Industrial Strategy a report on the conduct of all directors of the insolvent company who were in office in the last three years of the company’s trading. The report is to cover *any* conduct of the director which may assist the Secretary of State in deciding whether to seek a disqualification order against, or a voluntary disqualification undertaking from, a relevant director. In lieu of initiating disqualification proceedings, the Secretary of State may accept a voluntary disqualification undertaking from a director to speed up the process of removing the director from the realm of corporate directorships. This procedure avoids the expense and delay of court proceedings. Disqualification undertakings will only be accepted where it appears expedient in the public interest for this route to be followed.

In deciding whether a person is unfit to be concerned in the management of a company, the court will consider the full range of the director’s conduct, including the extent of the director’s responsibility for:

- the causes of the company (or any overseas company) becoming insolvent;
- having caused the company to breach the law; and
- breach of fiduciary duty or breach of the law by the director himself or herself.

For unfitness, in general terms, a court is looking for evidence of a lack of probity, integrity or honesty, not just commercial misjudgement. Liability for wrongful or fraudulent trading may also be considered in determining whether a director is unfit to be concerned in the management of a company.

The Small Business, Enterprise and Employment Act 2015 (the **SBEEA**) widened the scope of people who may be the subject of a disqualification order/give a disqualification undertaking. Where a person (whom the legislation calls the main transgressor) is disqualified or gives a disqualification undertaking and conduct of the main transgressor in respect of which the disqualification order is made (or which relates to the disqualification undertaking) resulted from the main transgressor acting in accordance with another person’s directions or instructions, that other person is also liable to be disqualified.

The SBEEA also introduced the concept of *compensation orders* which the court can make against a director being disqualified. Where a disqualification order has been made or a disqualification undertaking accepted, if the underlying conduct has caused loss to one or more creditors of the insolvent company, then the relevant person who is subject to the disqualification order or undertaking may be required to pay an amount as a contribution to the assets of the relevant company or for the benefit of a particular creditor or class of creditors.<sup>10</sup>

Disqualification means that, for the stipulated period, the relevant person is barred from being a director of a company or otherwise being concerned in the management of a company or from acting as an insolvency practitioner.

<sup>9</sup> An insolvency practitioner appointed by a secured creditor under security comprising a full fixed and floating charge over a company’s assets.

<sup>10</sup> In the case of *Re Noble Vintners* [2019] EWHC 2806 (Ch) the court made a compensation order of in excess of GBP500,000 against the disqualified director.

# Duty to consider creditors' interests where the company is, or is likely to become, insolvent

The general duties of a director (previously a matter of common law and equitable rules) are codified in sections 171 to 177 of the Companies Act 2006. A company may provide for more onerous duties in its articles, but the articles may not dilute the statutory duties.

While a company is solvent and trading normally, the directors' primary consideration remains, as before, to think of the interests of its shareholders – although this duty is expressed as a duty to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

When a company finds itself in financial difficulties (either likely to become insolvent or when it is actually insolvent),

the common law position is that the primary duty to act in the best interests of the members is displaced by a duty to have regard to the interests of the general creditors so that the interests of creditors take precedence over the interests of the shareholders. The Companies Act 2006 preserves the common law position by including a proviso (in section 172(3)) that the duty to promote the success of the company is subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

It has been confirmed by the courts that this proviso has the effect of preserving the precedence given to the interests of creditors in the event of insolvency; that is, that section 172(3) simply preserves the common law position with regard to considering or acting in the interests of creditors.



The principles below can be drawn from the cases considered by the courts since the Companies Act 2006 came into force:

- (a) Established, definite insolvency is not a pre requisite for the directors to be required to consider the interests of creditors<sup>11</sup>.
- (b) The directors' knowledge as to whether the company is insolvent or of doubtful solvency is a subjective matter but claims of "blissful ignorance" can expect rigorous examination.
- (c) Where the company is insolvent or is *likely to become insolvent* – which in this context means insolvency is **probable** – the directors must take the interests of creditors into account<sup>12</sup>.
- (d) Where a company is actually insolvent, the creditors' interests are "paramount". Short of actual insolvency, the extent to which creditors' interests are paramount or are merely to be considered (without being decisive) is a point on which clarification from the courts is awaited.
- (e) The duties imposed on directors are ordinarily subjective ones ie the question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company/creditors but rather whether the director honestly believed at the time that his or her act or omission was in the interests of the company/creditors. In practice, where the act or omission results in a substantial detriment to the company/creditors, the directors will have a harder task persuading the court that they honestly believed it to be in the company's interest<sup>13</sup>.

(f) The subjective test in paragraph (e) above becomes an objective one (that is, the director's actions are subject to a reasonableness assessment) in two circumstances:

- the subjective test only applies where there is evidence of actual consideration of the best interests of the company; if there is no evidence of any such consideration, the proper test will be objective – whether an intelligent and honest man in the position of a director of the company concerned could, in the circumstances, have reasonably believed that his actions/decisions were for the benefit of the company; and
- where a very material interest, such as that of a large creditor (whether an immediate, contingent or prospective creditor) is unreasonably overlooked without objective justification, and not taken into account, the objective test will apply.

In summary, the position will, as before, very much depend on the facts and the exercise of commercial judgement based on those facts. We set out below some practical steps which directors should take to ensure they are fully apprised of the company's position, and its impact on their duties, whether to comply with their Companies Act duties or to avoid wrongful trading.

<sup>11</sup> Capitol Films Ltd (in Administration) [2010] EWHC 2240; Bilta (UK) Ltd (in liquidation) v Nazir supra and, in the Court of Appeal, [2013] EWCA Civ 968; Re HLC Environmental Projects Ltd (in liquidation) [2013] EWHC 2876; Goldtrail Travel Ltd (in liquidation) v Abdulkadir Aydin and others [2014] EWHC 1587.

<sup>12</sup> BTI v Sequana [2019] EWCA Civ 112.

<sup>13</sup> BTI v Sequana (supra).



## Group of companies

A group of companies often acts as though it is a single legal entity. It must be remembered, though, that each company is distinct. However artificial it may sound or seem, a director of a number of companies in a group must wear his or her hat as director of each company in turn, individually, and consider the financial position of **that** company alone in the light of the above legal considerations. The rationale of this is that if one company goes into liquidation, its creditors are not going to derive any comfort from knowing that the other companies in the “group” survived.

The Companies Act 2006 introduced provisions governing directors' conflicts of interest. The key change from the old law is that there is now a positive duty for directors to avoid potential conflicts of interest. Where a director holds a number of directorships within a group of companies, the fact that one of the companies is in financial difficulties may give rise to potential conflicts of interest (for example where a parent company funds a subsidiary, where there are cash sweeping agreements or where there are intra-group guarantees).

The director should ensure that the financial difficulties have not caused a potential conflict of interest with their position as director of other companies within the group. Where there is a potential conflict of interest, consideration should be given to whether shareholder ratification is possible or whether the relevant director might resign from one or more of his or their positions or recuse himself or herself and take no part in the board discussions or decision-making at one company or another.

# Practical steps

It is impossible to attempt to list *all* the practical steps which directors of companies in financial difficulty might or should take in particular circumstances. Much will depend on the facts of the particular case. The following ideas for directors, however, will be applicable to many situations:

- ensuring the company has adequate and proper up-to-date financial information (including budget, cash flow and outcomes – particularly short-term cash flows);
- taking regular legal advice;
- scrutinising expenditure and cash outflows carefully;
- having a suitable business plan and business rescue plan, including plans for minimising losses;
- if a director has material doubt about the financial viability of a company, seeking independent professional advice in this respect;
- acting in concert, wherever possible, as the advocacy of, for example, cessation of trade by one director would place a correspondingly greater burden on the remaining directors should they need to justify a decision to carry on;
- carefully monitoring compliance with financial and other covenants in any agreements with lenders;
- considering the appointment of a Chief Restructuring Officer;
- engaging with D&O insurance providers (ensuring any policy also includes ex-directors);
- preparing suitable fall-back plans for a formal insolvency; and
- monitoring closely variables important to the company's financial health and holding regular (carefully minuted) board meetings to consider the company's up-to-date position.

# Key contacts

If you require advice on any of the matters raised in this document, please call any of our partners or your usual contact at Allen & Overy.



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