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Chapter 3

Directors and Insolvency: Dangers and Duties


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Nobody envies directors caught up in a restructuring. Tough decisions need to be made and not everyone will get what they want or expect, and those decisions will be subject to intense scrutiny from disaffected stakeholders. Moreover, directors risk the unpleasant prospect of personal liability for their actions and pressure upon them is not easing up.

In the aftermath of the financial crisis, a common view was held that whilst institutions may have been punished, the senior executives responsible for misbehaviour have largely escaped punishment. A number of governments have reacted to this sentiment, along with recent high-profile failures of businesses where at least partial blame was attributed to the actions of the directors of those businesses, and have pushed an agenda of personal accountability. This makes it more incumbent than ever on directors to ensure that they can satisfy the myriad of legal obligations placed on them, as they confront the financial difficulties of their companies.

Controls on Directors

There are certainly good reasons for the law to regulate directors' actions, particularly relating to insolvency. In a balance sheet insolvency, the economic value of the company breaks in the creditors' debt and not the shareholders' equity. However, in the absence of regulations the directors may take actions in the interests of themselves or the shareholders and not the creditors who hold the remaining economic interest in the company. Such actions include shifting assets out of the company (and so out of the reach of creditors) or engaging in highly speculative investments or loss-making activities. The losses caused by those actions will be borne by the creditors. The shareholders will usually be protected by limited liability and will be no worse off as the value of their equity has already been reduced or completely depleted.

To mitigate the potential harm to creditors, the law may impose controls on directors including:

- an obligation on directors to file for insolvency;
- making directors personally liable for increased liabilities of the company;
- shifting directors' duties from being owed to the shareholders to being owed to the creditors of the company; or
- challenges to transactions prior to an insolvency process that are detrimental to the general body of creditors.

Versions of the fourth type of control are common across most jurisdictions, whilst there is more variation in which of the other controls various jurisdictions adopt.

Obligation on Directors to File for Insolvency

English law does not impose a strict obligation on directors to file for an insolvency process when they become, or should have become, aware of the company's insolvency. However, many other European jurisdictions do. For example, in Germany directors have 21 days to file for insolvency, in France they have 45 days, and in Spain, they have two months.

Personal Liability for Directors for Increased Liabilities of the Company

In England and Wales, where directors are not explicitly obliged to file for insolvency, "wrongful trading" is the main impetus for directors to put an insolvent company into administration or liquidation.

The criteria for wrongful trading are set out in sections 214 and 246ZB of the Insolvency Act 1986. Directors face being personally liable for an increase in the net deficiency of a company's assets between the time the directors knew, or ought to have concluded, that there was no reasonable prospect of a company avoiding an insolvent liquidation or administration and the commencement of the subsequent insolvent liquidation or administration. Directors found liable for wrongful trading may also be disqualified from acting as directors or have restrictions placed upon their capacity to act as directors in the future.

There is a defence against wrongful trading if the director concerned took every step that they should have taken with a view to minimising the potential loss to the company's creditors. A higher standard will be required of a more skilled or experienced director, for example, a professionally qualified director such as an accountant. It is crucial that the board minutes or other written evidence records what steps are being taken to protect creditors, as the burden of proof in establishing the defence will be on the directors. Engaging professionals to advise on wrongful trading can be helpful to directors, both for the advice received and in demonstrating that steps are being taken to minimise losses to creditors.

It is tempting for directors who are worried about personal liability for wrongful trading to get themselves out of the situation by either resigning or putting the company immediately into an insolvency process. Neither of these may be advisable. Resigning as a director will not absolve the liability for wrongful trading. Indeed, by resigning, the now former director can be said to have failed to take every step to minimise creditors' losses. This is particularly the case where the director's resignation has left a skills or knowledge gap in the company's board. Immediately putting the company into an insolvency process which is destructive of value may contravene the directors' duty to the company's creditors.

Duties Owed to Creditors

The Companies Act 2006 partially codified directors' duties in England and Wales. Section 172(1) provides that directors have a duty to promote the success of the company for the benefit of its members as a whole. However, this is subject to a requirement in "certain circumstances" to act in the interests of the creditors of the company. The English Court of Appeal has recently confirmed that these circumstances include not only insolvency but a period prior to insolvency if the directors knew, or ought to have known, that insolvency was probable (*BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112).

This shift in directors' duties, from being owed to shareholders to owed to creditors upon or near insolvency is more prevalent in common law jurisdictions than in civil jurisdictions. Many of the notable cases originate from Australia and New Zealand. However, this is not a universal rule and certain jurisdictions retain the primacy of duties owed to shareholders even where a company is insolvent. Conversely, the EU's proposed directive on preventative restructuring frameworks will require its member states to lay down rules requiring directors to have due regard for creditors' and other stakeholders' interests where there is a likelihood of insolvency.

Directors of distressed companies should consider carefully, and take professional advice if necessary, if a duty to act primarily in the interests of creditors has been triggered. It is advisable for the directors to record in board minutes how the creditors' interests have been duly considered and the reasons why the board's decisions are in the interests of creditors. This will mean a different way of operating from when shareholders' interests were being primarily considered. However, this does not necessarily mean that a company cannot continue its business, as in many cases, it will also be in the creditors' interests for the company to carry on trading.

The shift in directors' duties towards creditors can be problematic in a group restructuring. Directors of an insolvent subsidiary can be caught between the competing demands of its creditors and its parent company. This can be complicated when the same individuals are directors of different companies within the same group. English law and many other jurisdictions do not allow directors to consider their duties on a group-wide basis, as they must consider the interests of the particular company of which they are a director. Prudent directors will appoint their own lawyers who are independent to those advising the company or the wider group to help them navigate these issues and avoid any potential conflict.

Challenges to Pre-Insolvency Transactions

England and Wales, like most jurisdictions, allows for certain transactions which had a detrimental effect on a company's creditors to be challenged during an insolvency process. The main types of challenge are transactions at an undervalue, transactions defrauding creditors, preferences and avoiding a floating charge. The risks of these transactions being subsequently challenged should be considered by directors, as where it is not feasible to reverse the transaction, directors may be required to compensate the company for the loss suffered.

Transactions at an Undervalue and Defrauding Creditors

Transactions at an undervalue involve a company transferring an asset to another party for no consideration or for significantly less than its market value. A transaction at an undervalue can be challenged by a liquidator or administrator if:

- the company was insolvent or became insolvent as a result of the transaction (insolvency is presumed if the transaction is with a connected person such as a director);
- the transaction occurred within the two-year period prior to the onset of insolvency; and
- the transaction was not made in good faith, for the purpose of carrying on the business and there are no reasonable grounds for believing that the transaction was for the benefit of the company.

A transaction at an undervalue can also be challenged under section 423 of the Insolvency Act 1986 if its purpose was to put assets beyond the reach of a creditor. These are so-called "transactions defrauding creditors". Despite the name, there is no need to show fraud or any dishonesty on the part of the company or its directors, just that the transaction was carried out with a purpose of removing assets from creditors. There is also no requirement that the company was insolvent or became insolvent due to the transaction. Unlike the other types of challenges which are brought by an administrator or liquidator, a claim for a transaction defrauding creditors can be brought directly by creditors or any other party prejudiced by the transaction.

Preferences

Preferences are transactions that the company carries out or permits to happen which, upon a company going into administration or liquidation, puts a creditor in a better position than it would otherwise have been. This can include a company paying off a director's loan account ahead of paying other creditors, or the granting of security to an unsecured creditor. For a transaction to be successfully challenged as a preference:

- the company must have been insolvent at the time of the preference or become insolvent as a result of the preference;
- the transaction must have occurred no more than six months prior to the onset of insolvency (if to an unconnected person) or no more than two years prior (if to a connected person); and
- the granting of the preference must have been motivated by the desire to prefer the particular creditor (i.e. to put it in a better position than it would have otherwise been). This is presumed when the recipient of the preference is connected to the company.

Avoiding Floating Charges

Floating charges are a form of security that allows the security provider to freely deal with the class of assets charged until the floating charge is crystallised, e.g. upon an event of default in a loan agreement or insolvency. If granted within one year (to an unconnected person) or two years (to a connected person) prior to the onset of insolvency, a floating charge may be avoided to the extent it secures "old money". These are funds already advanced to the company prior to the floating charge being granted.

Public Companies

Directors of public and listed companies have to bear an even heavier burden. A particular concern of regulators will be the flow of information and need to make sure investors are not misled by directors.

The directors will need to comply with disclosure rules such as those in the Market Abuse Regulations or the AIM Rules. There is a limited ability to delay disclosure where immediate disclosure may prejudice the company's legitimate interest, the market is not likely to be misled and the company is able to ensure the confidentiality of the information. For example, if there are negotiations in progress.

A further risk in withholding information from the public is that a director can commit a crime if they mislead the market. A director does so if they knowingly or recklessly make a statement that is false or misleading in a material respect or they dishonestly conceal any material fact. Directors may also be held personally liable if they made a false or misleading statement in any prospectus issued as part of a public fundraising.

Until "cleansed" by publication the facts of a company's financial difficulties or planned restructuring may constitute inside information. Directors should avoid any dealing in shares, options and other securities of the company, or they run the risk of civil and criminal liabilities for insider dealing or market abuse.

Cross-border Difficulties

Directors of companies operating across jurisdictions should take steps to clarify what obligations apply or may apply to them upon an insolvency. A striking example of what can go wrong is the case of *Kornhaas v Thomas Dithmar, acting as liquidator of the assets of Kornhaas Montage und Dienstleistung Ltd* (C-594/14), where the European Court of Justice ("ECJ") found that the director of an English incorporated company was personally liable under German law for payments the company had made after becoming insolvent. Despite being registered in England, the company's "centre of main interest" was in Germany. On this basis, the company's insolvency was subject to German law as per the EC Insolvency Regulation 2000 (since recast). The ECJ held that the personal liability for payments by the company was linked to the failure to file for insolvency within 21 days (which, as referenced above, is a requirement of German, but not English law). Accordingly, this requirement to file applied to the director even if as a director of an English company she was otherwise subject to English law directors' duties.

The interaction of obligations of directors in different jurisdictions also needs to be considered when planning a restructuring. For example, the plan for a group-wide out-of-court restructuring may be derailed if the directors of one group company are required by law to file for insolvency before the restructuring can be implemented.

Protection for Directors

Given the risks that directors assume, companies often have to provide some level of protection to directors. Otherwise it can be difficult to persuade individuals to serve as directors and to continue serving during difficult times. The two most common protections offered are indemnification by the company and directors' and officers' ("D&O") insurance.

An indemnity from the company cannot be all encompassing. England and Wales section 232 of the Companies Act 2006 restricts a company's ability to indemnify a director in respect of negligence or a breach of trust or duty in relation to the company. Section 234 prevents a company from indemnifying a director for criminal fines, regulatory penalties and defence costs for criminal or regulatory proceedings where the director was found guilty.

A more critical limitation of indemnities is that, if called upon, an indemnity would only make a director an unsecured creditor of the company. Therefore, an insolvency scenario, the time when the indemnity is most likely to be needed is also when the indemnity is least likely to have any value. Accordingly, directors may seek indemnification from elsewhere in the group, or from a controlling fund or sponsor, which is more likely to meet any indemnity claim.

The advantage of D&O insurance over an indemnity from the company is that the payer would be a (hopefully) solvent insurer rather than a financially distressed company. However, care and specialist advice will need to be taken to ensure the cover is as expected.

It is common for insurance policies to not pay out in respect of a risk that is against public policy. Directors may find they are not covered for criminal liabilities and, in some jurisdictions, civil fines. Therefore, criminal liabilities are one area where directors are unlikely to benefit from either an indemnity or a D&O policy. At one level, this is sensible as generally insulating individuals from the legal consequences of criminal behaviour can lead to perverse consequences. However, there may be technical criminal offences which do not require any dishonesty or malevolent intent on the directors' part. With more and more obligations imposed on directors, the uncovered risks they run are increasing.

Even where cover is not prohibited by the law, the drafting of the policy may still leave directors exposed. For example, a D&O policy will typically provide cover for a damages claim which is made against a director. However, some jurisdictions do not consider a claim against directors under insolvency laws to be a damages claim and, consequently, that claim may not be covered by the D&O policy. Directors, therefore, would be wise to seek both insurance and local law advice if there are concerns about the extent of a policy's coverage.

A common area of concern in relation to coverage is the extent of the "insured *versus* insured" exclusion. Insurers will typically exclude claims made by one insured party against another. A D&O policy will usually insure both the company and its directors, so an insured *versus* insured exclusion may apply when a company brings a claim against its own director, as would be the case in England for a breach of directors' duties. Some comfort for directors can be found if, in an insolvency process, actions brought in the name of the company by insolvency practitioners controlling the company are carved out of the insured *versus* insured exclusion.

There is a risk that a D&O policy may encourage claims against a director if claimants believe the deep pockets of an insurer will meet their claim. However, in general a good D&O policy is likely to be of benefit to directors and almost certainly of more benefit than an indemnity from an insolvent company. Indeed, it is often worth shadow directors, who may run many of the same risks as directors, being formally appointed as directors so that they can benefit from the policy.

Directors and former directors should also bear in mind that usually the D&O insurance policy will be taken out by the company, but in an insolvency process the directors cede control of the company to an insolvency practitioner. Therefore, as a practical matter, directors should ensure they keep their own copy of the D&O policy documents.

Future of Directors' Liability in the UK

In the UK, attitudes towards directors of insolvent companies have hardened after a string of high-profile failures including BHS and Carillion. In the former case, the previous owner of BHS, Sir Philip Green, was heavily criticised in the press and in Parliament for selling to a consortium of inexperienced investors, headed by a twice bankrupted businessman. Shortly after the sale, BHS went into administration with its pension fund among its most heavily affected creditors. After enormous political pressure, Sir Philip agreed to contribute £363m to the BHS pension fund.

The BHS case has inspired a raft of new proposals by the UK Government. A pension-specific measure is a proposed new criminal offence of wilful or reckless behaviour in relation to a defined benefit scheme. Another proposal with wider application is to make directors of a holding company liable in relation to the disposal of an insolvent subsidiary. According to the proposal, liability would attach to a holding company's directors if:

- the subsidiary was insolvent at the time it was sold;
- within 12 months of completion of the sale the disposed of subsidiary enters administration or liquidation;
- the interests of creditors are adversely affected during the period between the sale and administration or liquidation; and
- the holding company's directors could not have reasonably believed that the sale would lead to a better outcome for creditors than the administration or liquidation of the subsidiary.

The UK Government has rowed back on an earlier proposal to make any holding company directors found guilty of this offence to pay compensation to the sold subsidiary's administrators or liquidators. However, guilty directors would still risk being disqualified to act as a company director and the associated financial penalties.

Detailed draft legislation is still awaited, but the UK Government is keen to implement the new liabilities for directors. This is despite strong scepticism from the professional restructuring community. In part, this relates to concerns about how directors of holding companies (and potentially entities further up the group structure) will manage the conflicts with their duties to their own company and shareholders. There are also concerns that holding company directors, fearing for their own personal liability, may place a subsidiary into an immediate value-destructive insolvency process rather than risk a distressed sale (which may ultimately produce a better outcome for creditors despite the risks).

It will be interesting to see whether any changes in the UK inspire other jurisdictions to follow suit.

Brexit means the EU proposed directive of preventative restructuring frameworks is unlikely to be directly relevant to UK directors. From an English law perspective, this would have broadened the category of parties' whose interests' directors would need to have due regard for when there is a likelihood of insolvency to "other stakeholders". The directive will have a larger impact on the remaining EU members where, for the first time in many jurisdictions, directors will owe duties to creditors when the company is in the vicinity of insolvency.

Conclusion

Undoubtedly, the law should take a firm stance where there has been clear and genuine wrongdoing by directors. However, financial distress and insolvency will be an unfamiliar and bewildering situation to most directors. Governments should as a result be wary of imposing too onerous a burden on directors, and too high a risk of personal liability. Companies need individuals to be willing to accept directorships and to remain in office when the company is in distress. Nonetheless, the trend continues to be to expect more of directors not less. The particular course of action directors will need to adopt will vary with the situation, but good practice would be to:

- hold regular board meetings focused on the company's financial difficulties. These may have to be held more frequently than the practice during better times. Minutes should be carefully kept to record decisions made, the reasons for them and that due consideration was given to the directors' duties including, where relevant, those owed to creditors of the company;
- take professional advice, ideally from insolvency and corporate recovery specialists. Directors should also consider whether it would be appropriate to appoint their own legal advisors independent of the company's or the group's advisors;
- ensure they have up-to-date and accurate information on the company's affairs, assets and liabilities. This should include a list of all known current and prospective creditors and other crucial stakeholders. The liquidity of cash is crucial and directors should have a cash flow projection for the immediate future;
- avoid committing the company to large new liabilities or new creditors. If this is necessary to continue trading directors should consider how new creditors can be protected and how the liabilities to the new creditors will be met; and
- review (with the assistance of professional advisors if necessary) the company's D&O insurance coverage.

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Jat specialises in a range of debt finance transactions, acting for a diverse range of stakeholders including credit and special situations funds, corporate clients, sponsors, bondholders and senior and mezzanine lenders in relation to, amongst other things, workouts and restructurings.

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