Client guidance note

Guidance note on directors' duties

This publication gives general guidance only. It may not always apply and should not be relied on in place of specific legal advice.

Update – June 2020

Please note that some directors' duties in relation to insolvency have been temporarily relaxed as a result of the Coronavirus pandemic. Please refer to this article on our Coronavirus advice hub for the latest information.

As a matter of law, directors have duties to the company for which they act.

This guidance note is intended to provide general advice to directors on:

- Duties owed by directors.
- Tests to establish whether a company may be insolvent.
- The duty that a director will owe to a company in circumstances where there is a question-mark over its solvency (i.e. the paramount duty to creditors).
- Potential areas where directors might become personally liable if a company goes into liquidation or administration.
- The specific types of transactions which can be undone if a company goes into formal insolvency procedures.
- Matters to which directors should have regard in relation to their management of the company.
- A checklist of actions that can be taken in order to try to (a) minimise risk, and (b) ensure that the financial viability of the company is continually monitored.

Directors' duties generally

As a matter of law, directors owe general duties to the company for which they act, namely:

to act within their powers: a director must act in accordance with their company's constitution (i.e. the company's Articles of Association);

to promote the success of the company for the member's benefit: a director must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In order to meet this obligation, a director must have regard (amongst other matters) to:

the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct; and the need to act fairly as between the members of the company.

to exercise independent judgment: this duty is not infringed by a director acting in accordance with an agreement entered into by the company that restricts the future exercise of the directors' discretion or in a way authorised by the company's constitution.

to exercise reasonable care, skill and diligence: a director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by the director in relation to the company and the general knowledge, skill and experience that the director actually has. This duty includes the following: obey lawful instructions from the company (with the company in this context acting through its shareholders); to display such reasonable care in the carrying out of your responsibilities as an ordinary prudent person might be expected to take in the same circumstances; to carry out responsibilities personally (unless authorised to delegate them); and to act at all times in good faith.

to avoid conflicts of interest: this includes a duty to avoid conflicts of interest between personal interests and the interests of the company.

not to accept benefits from third parties: directors must not accept any benefit (including a bribe) from a third party which is conferred because of their role as director or doing or not doing anything as a director.

to declare an interest in a proposed transaction or arrangement with the company: a director must not make a secret or illegal profit from property, assets or opportunities which are properly the company's. Directors must declare to the other directors the *nature* and *extent* of any interest, direct or indirect in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for the duty to apply. An interest of another person in a contract with the company may require the director to make a disclosure under this duty, if the other person's interest amounts to a direct or indirect interest on the part of the director. Such declarations must be made before the company enters into the transaction or arrangement.

As stated above, these duties are owed collectively to the company. In ordinary trading circumstances (where there is no question-mark over the solvency or financial position of the company), this is generally interpreted as meaning that directors must act in the best interests of the company's shareholders.

The duties are owed by all directors, regardless of the role they play and the basis of their holding office.

Insolvency

The tests: There are generally two broad tests for ascertaining whether a company is insolvent. The first is referred to as a test for commercial solvency. The second is referred to as balance sheet solvency.

A company is deemed to be solvent on a commercial basis if it is able to meet its current debts as they fall due. It follows that a company is considered to be insolvent on a commercial basis if it is unable to meet its current debts as they fall due.

As to the balance sheet test, a company will be considered insolvent if the value of its assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

Directors' duties where the company is in financial distress: Where a company is (a) insolvent, (b) of doubtful solvency, (c) on the verge of insolvency, or (d) on the verge of or likely to go into insolvent administration, and there is money owed to creditors which is at risk, the directors have to consider the interests of the creditors as paramount and take those into account when exercising their functions. It follows that a director's general duties (as summarised above) change from a situation where they are owed principally to shareholders, to one where they are owed principally to creditors.

Perhaps the most critical consequence of this is the fact that there may come a time when it is in fact in the best interests of the creditors that company's trading should cease, and some formal insolvency procedure should be entered into. Directors run significant personal risks if they do not bear this in mind and continue to trade a company which is in financial difficulty, in particular where it is later established that no reasonable director would have continued to trade.

The other critical point which must be made is that if a director acts in breach of their duties, they can potentially face severe penalties.

Potential personal liabilities: The Insolvency Act 1986 contains a number of provisions under which directors can be made personally liable. In short, they are:

- Misfeasance or breach of duty (Section 212 of the Insolvency Act 1986).
- Fraudulent trading (Section 213 of the Insolvency Act 1986).
- Wrongful trading (Section 214 of the Insolvency Act 1986).

Misfeasance or breach of duty

A director may have an order made against him requiring him to compensate the company for loss arising as a result of his misfeasance or breach of duty (Section 212).

The section can apply to an officer of the company (e.g. a director or secretary), a liquidator or former administrator of the company, or any other person that is concerned with or has previously taken part in or been concerned with the promotion, formation or management of the company.

Under the provision, if a director (a) has misapplied or retained, or become accountable for, any money or other property of the company or (b) has been guilty of any misfeasance or breach of any fiduciary or other duty (as to which, see above), a court may, if an application is made by the Official Receiver, the administrator or the liquidator, compel the director to repay any monies which are properly the company's or, alternatively, compel the director to contribute such sum of money to the company's assets by way of compensation as is necessary to make good the misfeasance or breach of duty.

In essence, the section provides a summary remedy against directors who have broken their common law duties (set out in the section above headed 'Directors' duties').

Fraudulent trading

A director who is knowingly a party to the carrying on of a business with intent to defraud creditors or for any fraudulent purpose commits both a criminal offence and, if the company goes into liquidation or administration, can face being personally liable to make a contribution to the company's assets.

It is not enough to show that the company continued to run up debts when a director knew that it was insolvent; there has to be actual dishonesty involving real moral blame.

Conversely, if a director continues to trade the company actually knowing that the debts that it will continue to incur will have no prospect of being paid in the future, then this can amount to fraudulent trading.

Fraudulent trading proceedings are very rare, since the burden of proof, being criminal, is high. Instead, a liquidator or administrator is more likely to succeed if he brings wrongful trading proceedings, where the standard of proof is less strict.

Wrongful trading

The balance sheet test for insolvency is used when determining whether there has been wrongful trading.

A director will be 'guilty' of wrongful trading if (a) the company has gone into insolvent liquidation or administration and, (b) before that time the director knew **or ought to have concluded** that there was **no reasonable prospect** that the company would avoid going into insolvent liquidation or administration, and (c) that person was a director.

There is a caveat to liability arising in this way, which is that if, from the time that a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation/administration, the director took every step with a view to minimising the potential loss to the company's creditors as the director ought to have taken.

The very real difficulty for directors considering whether they are trading wrongfully is that the standard by which they are assessed is objective. It is not linked directly to their particular skills and experience. Rather, the standard by which people are assessed is the standard of a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the actual director, and (b) the general knowledge, skill and experience of the actual director.

In other words, there is a minimum standard of knowledge, skill and experience which the law expects a director to have. If, in turn, the director's actual knowledge, skill and experience exceeds the general standard, they will be assessed according to the higher standard.

There is no hard and fast rule, nor standard, by which an assessment can be made at any given time. A director can become liable for wrongful trading if, judged by the objective standard, there was a point in time when they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation/administration, but they in any event continued to trade.

When that 'point in time' arises (if ever) is extremely difficult to assess. As guidance, however, we would advise directors to regularly ask themselves the following questions:

- Do you honestly believe that there is a reasonable prospect that the liabilities the company is about to incur will be paid in full at the time they fall due?

If not, then you should ensure that the company does not incur such liabilities.

- Having taken all reasonable steps to ascertain the relevant facts, is there a reasonable prospect that the company will avoid going into insolvent liquidation/administration?

If not, you should take every step that you ought to take with a view to minimising the potential loss to the company's creditors. This will usually involve immediately taking advice from an insolvency practitioner as to the formal insolvency procedures that are available.

If a director is found 'guilty' of wrongful trading, then, on application to the court by the liquidator/administrator, they can be required to compensate the company for the loss that it has suffered. This does not mean that the director will become personally liable for all of the company's debts. However, they can become liable for the difference between the company's deficit at the time when they ought to have concluded that the company was insolvent and the time at which they in fact reached that conclusion (and took steps to put the company into a formal insolvency procedure).

It should be noted that, whereas this provision is contained within the Insolvency Act 1986 and applies in all liquidations and administrations, it is not always pursued by a liquidator/administrator (even if there are grounds for a claim). Further, if an action is pursued, it may be possible to take steps to compromise the claim before it reaches court.

Other relevant provisions

Transactions at an undervalue (Section 238 of the Insolvency Act 1986)

This section is aimed at gifts of a company's property, or those transactions in which the consideration **received** by the company is significantly less than the value of the consideration **provided** to the company.

It is aimed at preventing the disposition of company property for less than its true value, in particular at a time when the company is potentially insolvent (and so when the creditors are particularly keen to ensure that the potential assets available to them are not wrongfully depleted).

As with the preceding sections of the Insolvency Act 1986, this section applies in administration as well as liquidation.

If a court, looking at all the relevant facts, considers that there has been a transaction at an undervalue, it has extremely wide-ranging powers to make an order to restore the position to what it would have been if the company had not entered into the transaction.

This does not necessarily mean that a director becomes liable for the 'shortfall' from any such transaction, although this is a potential outcome if it can be seen that they have clearly benefited financially.

Further, there is a caveat in the provision which makes clear that the court cannot make such an order if it can be established that the company that entered into the transaction did so in good faith and for the purpose of carrying on its business, and that at the time it did so there were reasonable grounds for believing that the transaction would benefit the company.

In terms of what practical steps a director can take to avoid transactions at undervalue, each case must be looked at on its own facts. A director should, however, factor into any consideration of any potential transaction the company might now be entering into, the prospect that someone might, at a later point in time, seek to argue that the transaction was at an undervalue. We would recommend taking specific advice on any transaction that you are concerned about.

Preferences (Section 239 of the Insolvency Act 1986)

A company gives a preference to a person if that person is one of the company's creditors (or a surety or guarantor) and the company does anything or allows anything to be done which has the effect of putting that person into a position which, if the company subsequently goes into insolvent liquidation or administration, will be better than the position it would have been in if that thing had not been done.

If a preference is given to a connected person (which includes directors and their relatives, and companies with common control), then the period which is looked at to see whether any preferences have been given is two years back from the date of the onset of formal insolvency. In all other circumstances, it is six months.

For any claim in respect of a preference to succeed, the liquidator must show that the company which gave the preference was influenced by a desire to put the beneficiary in a better position in insolvency than if it had not been done. This is presumed if a preference is given to a connected person.

Two of the most obvious examples are as follows:

- If money is not currently available to pay all creditors in full and on time, paying one of them (or a group of them) and not paying others.
- Paying creditors who hold personal guarantees in respect of the company indebtedness.

It can be seen, therefore, that considerable care needs to be taken in relation to what payments and what benefits are given to the company's creditors. In the event that any course of action puts any one creditor in a better position than it would have been if 'that thing had not been done', then a preference may have taken place. Subject to complying with the relevant provisions of Section 239, such transaction could well be unwound in liquidation or administration.

General comment: Whereas transactions at an undervalue and preferences do not, of themselves, lead to personal liability for directors, sometimes personal liability is incurred. In most circumstances such transactions will impact negatively on the director via the liquidator or administrator's report to the Secretary of State. That report will be used to consider whether disqualification proceedings should be brought against a director.

Disqualification

Directors can be disqualified from acting or continuing to act as directors in varied circumstances. However, in circumstances where a company has become insolvent, it is quite common for the Secretary of State to bring proceedings against directors whom it considers unfit to continue to act as directors.

In each case where a company is placed into a formal insolvency procedure, the office holder (for example, the liquidator or administrator) is required to prepare a report for the Secretary of State on the director's management of the company concerned. That report often forms the basis of an action by the Secretary of State against the relevant directors, seeking their disqualification.

Examples of 'unfit conduct' which can lead to a director being disqualified include:

- Any misfeasance or breach of duty by the director in relation to the company.
- Any misapplication or retention by the director of any money or property of the company.

- The extent of the director's responsibility for the company entering into any transaction which is considered to be a transaction at an undervalue or a preference.
- The extent of the director's responsibility for any failure by the company to comply with accounting and filing requirements.
- The extent of the director's responsibility for the causes of the company becoming insolvent.
- Where a company has been paid in whole or in part for goods or services, the extent of the director's responsibility for a failure to supply.
- Misuse of the company's bank account.
- Taking inappropriate remuneration from the company (especially in circumstances where the company is in financial difficulties and creditors might not have been receiving payment on time).
- Failure to ensure that Crown debts (i.e. liabilities to HM Revenue & Customs) are paid.

Compensation orders: If a director has been disqualified and their conduct caused loss to one or more of the creditors of the insolvent company, the Secretary of State may seek an order from the court that the director to pay compensation. Alternatively, the court may accept an undertaking from the director to pay compensation.

General guidance: It a company ultimately goes into some form of insolvency procedure, the directors' management of the company will be scrutinised. If a director considers they are are in danger of acting in any of these ways in relation to any specific action, then they should seek legal advice.

As general guidance, however, a director should at the very least:

- Ensure proper accounting records are maintained, up-to-date and properly stored.
- Ensure that all relevant statutory registers are up-to-date, maintained and properly stored.
- Ensure that all filing requirements (in particular annual returns and accounts) are up-to-date.
- Ensure that there is no policy to delay payments to HM Customs & Revenue, in particular in order to facilitate payments to other creditors.

Checklist

The most important actions that a director should take to protect themselves are aimed at ensuring that they have full and adequate information on the company's cash flow, budget forecast and other management accounts.

We set out below a checklist of actions that a director should consider taking to protect their position:

- Ensure the company has adequate, proper and up-to-date financial information.
- Seek independent financial advice if you have any doubts about the financial viability of the company.
- Ensure that decisions regarding the company are properly recorded.
- Consult an insolvency practitioner to obtain advice on the alternative insolvency procedures which might be pursued.
- Keep a constant eye on transactions which the company is entering into, in particular to ensure that there is no question that they might be categorised as transactions at an undervalue or preferences. Take specific advice in relation to proposed actions if there is uncertainty.
- Review the matters which can lead to a finding of unfitness against a director.

Summary

A lot of the information above is daunting, not least because of the potential threat of personal liability, but also because of the very real difficulty facing any director trying to make an assessment of whether he or she should continue trading the company, or conclude that the company cannot in fact avoid going into a formal insolvency procedure.

If you have any questions on any of the matters set out above, or you require further guidance, please visit the Directors & shareholders page or the Restructuring & insolvency page on our website (www.crippspg.co.uk) or email Joanna Ford at joanna.ford@crippspg.co,uk.