SMES, DIRECTORS & SHAREHOLDERS

Directors' duties and responsibilities

What constitutes misconduct: Part 5. Non-payment of HMRC debts: VAT, PAYE, NiC

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INTRODUCTION

This is part 5 of a series of booklets considering the general question of directors' duties and responsibilities and in particular, what conduct can ultimately constitute a finding of "unfitness" and possible disqualification as acting as a director.

It deals with the issues of Non-payment of Crown debts (i.e. HMRC) or other non-pressing creditors.

Unfitness is governed by section 6 of the Company Director Disqualification act 1986 ("CDDa 1986").

This series of booklets is intended to guide you through the general standard of behaviour expected by the courts on either: (i) an objective basis – i.e. the standard expected of directors generally; and (ii) a subjective basis – i.e. the higher standard expected of directors having regard to their qualifications, skills and experience.

Although cases are always judged on their own individual facts, certain common threads can be determined from the various decisions made by the courts when determining unfitness pursuant to Section 6 of the CDDa 1986.

1 Non-payment of Crown debts – general principles

Non-payment of a Crown debt does not automatically result in a finding of unfitness leading to disqualification. It is a common misconception that it does.

Rather, the courts must look at each case on its own individual facts in order to determine the significance of the non-payment of a Crown debt.

In general the court will consider the differing treatment of the Crown to other creditors, whether the company had sufficient funds to pay the Crown and whether it was in fact using the sums due to the Crown to otherwise fund the other parts of the company's on-going business.

The same principles apply as regards other creditors, and is particularly relevant to banks or members of the public, where the priority to pay these specific categories of creditor appears to have been considered less important than other interests (either which the business relies on – i.e. trade creditors – or personal interests e.g. directors loans).

For the remainder of this article we will focus on the non-payment of Crown debts (which is perhaps the creditor most commonly singled out for preferential non-payment) but the principles are identical for any other category of creditor which is differently to other categories of creditor as described above.

2 How the allegations against directors are normally worded

Ordinarily, when dealing with a claim involving non-payment of a Crown debt, the director will be accused of funding the continued trading of the company by withholding taxes due to HMRC (i.e. VAT, PAYE and NiC). That is, trading to the specific detriment of the Crown.

Often the allegations relate to a director using monies meant for the Crown to fund the company's continued trading at a time when the company was insolvent. Alternatively, the director is shown as adopting a policy of deliberately not paying sums owed to the Crown and therefore unfairly discriminating against the Crown in favour of other creditors of the company.

However, the Secretary of State can sometimes make mistakes when drafting the wording of claims against directors.

Allegations of trading to the detriment of a particular creditor need to be carefully framed. For example, if it is shown that the director actually caused the company to trade to the detriment of not just one but a number of creditors, then this can defeat a claim of trading to the detriment of a specific creditor. This is even though trading to the detriment of a number of creditors may in itself be the basis for other claims constituting unfitness, disqualification claims have been struck out for being incorrectly phrased or focused.

3 What about non-payment of creditors other than the Crown?

As stated above, allegations of prejudicial treatment against certain categories of creditor can be just as severe as any claim of trading to the detriment of HMRC/ the Crown.

The reality is however that it is normally the Crown who doesn't get paid. When faced with an option of paying either the trade creditors or the Crown at times when the company is in financial difficulty, many directors choose not to pay the Crown in the hope that they can keep the business going and ultimately repay the outstanding Crown arrears. They often want to pay suppliers of the company as a means of keeping it going.

The reason for the emphasis, in common law and in statute, on the reasons for such sanction for non-payment of the Crown is by reason of its very nature as an involuntary creditor. The Crown does not supply anything vital to your business (although there is an argument that the provision of public services is a necessary commodity) and the withdrawal of its services will do little to affect a company's business.

However, for public policy purposes taxes must be collected and thus any failure to treat the Crown in an identical way to all other creditors will be subject to a severe sanction.

4 Does it matter if a creditor isn't chasing for payment of a debt?

Sometimes, a director might not pay a creditor because the creditor has not chased for payment of the debt. However, this is no defence to a claim of unfitness. It doesn't matter who "shouts loudest". Debts are supposed to be paid as and when they fall due.

5 What happens if the bank overdraft is paid off instead of a creditor?

Sometimes, directors choose to pay off the company overdraft or bank loan and thereby extinguish any potential claims pursuant to a personal guarantee they have given the bank. if a director chooses to take this course of action, it is a ground for a finding of unfitness, thus leading to disqualification.

This could also lead to recovery proceedings against a director as in these circumstances this type of transaction will constitute a preference within the meaning of Section 239 of the insolvency act 1986 (putting him/her in a better position than they would be in the event of an insolvent liquidation).

However, sometimes a payment is made in the ordinary course of business directly into the bank account and there is no way to avoid the overdraft being reduced. In such circumstances there may

well be relief for the director, but this will often depending on the timing, the situation and whether the director actually encouraged his payment rather than setting such funds aside for the purpose of the liquidation.

6 What if a director takes advantage of a non-pressing creditor's forbearance?

A person is guilty of misconduct if he/she has taken advantage of a creditor's general forbearance in getting paid. Using that breathing space to continue trading the company at the expense of that creditor is seen as misconduct which demonstrates unfitness.

This is often a problem which leads to wrongful or fraudulent trading claims against directors (as well as disqualification claims). Whether it be intentionally (fraud) or negligent (wrongful trading) allowing a creditor to supply goods, or a customer to pay a deposit or the entire consideration, when the director knew or should have known that during that period of forbearance the company would be placed into liquidation then s/he may be personally liable for the loss arising.

7 Can the court infer a policy of deliberate non-payment?

The courts will look to see whether there has been a policy within the company of unfair discrimination in terms of which creditors were and were not paid.

Even if there is no direct evidence of such a policy (e.g. in writing), the courts can infer there was a policy of unfair discrimination. They might base this on the fact that the company was withholding payment to a non-pressing creditor over a substantial period of time or where the unpaid debt owed to a single creditor formed a substantial proportion of the overall company debts.

There is no minimum period to which the court has to show such a policy was operated over, although a very short period may be insufficient to support any such claim against a director.

8 Transfer of assets and liabilities to another company

Where directors deliberately leave Crown debts unpaid and then transfer the assets and liabilities of the company to another business and then fail to make payment of the debts over a prolonged period, this failure can lead to a finding of unfitness.

The conduct of the company's business, the movement in assets, the record of payments to all categories of creditor and the personal benefit received by directors will all be contributory factors in assisting the court to determine whether a director should be disqualified (or, in more serious circumstances personally liable for repayment of the losses) for such misfeasance.

9 What if the level of debts remained generally constant?

If the amounts owed to non-pressing creditors remain generally constant over the company's period of trading, then it is unlikely that the court will infer a policy of discrimination ever existed.

However, this will depend on the treatment of other creditors. If other creditors' claims have decreased substantially over this period, or the company is shown to be generating huge profits and paying

substantial remuneration to directors or other associated individuals (e.g. shareholders) then this can be a form of reverse discrimination which can lead to a finding of unfitness on the part of that company's directors.

10 What if a director has a policy of only paying pressing creditors?

It is not just a deliberate policy of not paying non-pressing debts that can lead to unfitness. If a director operates a policy of deliberately only paying pressing creditors, this too is sufficient to lead to a finding of unfitness.

This is not unusual in circumstances where a company is finding it difficult to stay afloat and is just fire fighting with claims. At this point directors have to be confident that the prospect of the company recovering is realistic. Otherwise they should immediately wind-up the company (or place it into administration if one of the statutory purposes can be fulfilled) and avoid any preferential payments to creditors.

It is not always easy to do this in a pressured environment when the company is struggling to keep its head above water, and the court will consider any such misbehaviour which occurs over a very short period leading up to liquidation. It is a commercial reality that companies suffer great losses in the period leading up to insolvency, but it is essential that directors make the right decisions, do not use the company's assets to benefit themselves or a single creditor in the final days and ensure that all decisions are documented in board minutes for justification at a later date.

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