SMES, DIRECTORS & SHAREHOLDERS

Directors in the twilight zone

7 frequently asked questions

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INTRODUCTION

Directors of limited companies have primary duty under Section 172 of the Companies Act 2006 to promote the success of the company. In respect of conventional limited liability companies, this usually refers to making sufficient profit or acting in shareholders' best interests to the exclusion of most other groups or categories or stakeholder in the company.

However, when a company reaches a point of insolvency and is unlikely to avoid an insolvent liquidation (or other similar insolvency scenario) then directors duties alter and they must prioritise the interest of creditors of the company rather than the shareholders.

This has always been a historic position in case law but as from the commencement of the Companies Act 2006 (which supported this theme, which already existed in the Insolvency Act 1986) this became a stipulated fiduciary duty of directors even before insolvency occurs.

A breach of such a duty can lead to claims for a director breaching his fiduciary duties or, most commonly in insolvency proceedings, claims against directors for misfeasance, wrongful trading and perhaps even fraudulent trading. Please see our website which holds booklets which deal with such claims.

This booklet is designed to provide a brief guidance as to what directors should do if their company is struggling or appears to be on a path to failure, a scenario commonly referred to as the "twilight zone".

1 What is the twilight zone?

This is not a term defined by legislation but is a common reference to circumstances which define the final period of a company's trading pre insolvency. The "twilight zone" is often difficult to interpret until a company has already failed and you are looking back at what should have occurred in the period leading up to failure (or rather what the directors should have done during this period).

The twilight zone could, for example, commence once funding lines or applications have been exhausted or failed and the future looks uncertain. In such circumstances a director may have to make a decision as to whether the company should continue trading.

The insolvency legislation provides a remedy for liquidators and administrators to seek recovery of any assets distributed by directors of a company where such distribution is shown to have been for an undervalue sum (i.e. payment or goods given in exchange for other items or payment which were less than the value of such goods or monies, or no value was given) and for recovery of preference payments (where certain categories of creditors have been paid in priority to others).

Please see our booklets entitled "Preferring creditors" and "Undervalue transactions" which deal with these areas.

All of these remedies in insolvency proceedings relate to directors' decisions made in the twilight zone.

2 What are my duties when in the twilight zone?

This is varied and, by way of example (which applies to directors generally) they should comply with their fiduciary duties generally and as set out at Sections 172-177 of the Companies Act 2006. Our booklet entitled "Breaches of a director's fiduciary duties" deals with these general requirements.

However, more importantly than a majority of these duties, is how a director acts to protect third parties, particularly creditors, where a company is at risk of failing.

As creditors are not generally associated to the company, and are usually the biggest losers if a company fails, the legal position is that as soon as failure becomes a realistic possibility, directors should stop any assets leaving the company, should hold off payment to all creditors (although this may be difficult) and should only allow the company to continue trading where it is generating net profits.

3 Do these duties apply in all circumstances where the company is insolvent?

The answer to this is no – although directors do generally have to manage each and every situation and be able to justify decisions at a later stage (should matters deteriorate).

Companies are often insolvent, particularly when they commence trading, and so it is managing a way out or alternatively having a realistic strategy for the company's success that will determine the viability of any plans and the justification for any decisions to continue trading.

However, where insolvency occurs and looks like it is only going to get worse, or alternatively where the solvency of the company is unknown (perhaps because of the state of the accounting records and management information) then directors have to pay very real attention to the detail and be more careful when making decisions which could ultimately affect them personally.

4 What situations lead to these circumstances?

Sometimes it may be that the company is suffering a downturn in business but the company's business can be recovered by way of, for example, additional funding as a result of which insolvency proceedings may be avoided. This is not unusual for companies and indeed many companies go through this but it is for the directors to perceive the difference between these events and a scenario where the company cannot avoid liquidation.

However, in circumstances where (for example) a large customer ceases to use the company's business, or legal changes have an unforeseen and severe impact on the company's business, the make-up of the Board changes or a very key sales director, manager or otherwise resigns or is dismissed, where funding lines change or the bank withdraws certain types of facility, in all of these scenarios then directors could find themselves in the twilight zone with the additional responsibility to safeguard the company's assets in the event of an insolvency process being commenced. These circumstances are too numerous to list, and so it is for the directors to interpret when such events have altered their responsibilities.

6 What risks do I face as a director?

If a company is trading, then shareholders (even minority shareholders) could take proceedings on behalf of the company against directors personally (with the effect as outlined below) for a breach of the directors' fiduciary duties.

Alternatively, if a company is placed into an insolvency proceedings, a director will face a number of risks including the following:

1. **An appointed liquidator could file a negative report on the director's conduct and this will be passed to the Secretary of State.**
2. **The Secretary of State may institute director disqualification proceedings to disqualify that director from ever being a director of another company for a specific period, which will be anywhere between 2 and 15 years (dependent on the severity of the misconduct).**
3. **The appointed liquidator (or administrator, although this is rare) may sue the director personally for recovery of claims arising by way of misfeasance transactions. These transactions can include any monies repaid to that director (for example repayment of the director's loan account shortly before insolvency – our booklet on "Directors' loan accounts" deals with these issues) or any assets transferred to that director at below their market value.**
4. **Undoubtedly, if such a threat cannot be negotiated before it reaches court, the director will have to pay interest on any such sums (at the rate of 8% per annum over the period of years from the date of insolvency, which can be nearly as large a sum as the original claim).**
5. **The defendant director, if ordered to pay such sums in legal proceedings, will also be liable for the claimant's legal costs.**
6. **Ultimately as a result of the proceedings the director may find that they have a huge financial penalty in terms of the liquidator's claim, which would have been considerably lower if s/he sought legal advice earlier and/or negotiated a settlement.**
7. **It is not uncommon for the above proceedings to lead to the director losing his family home and even being declared bankrupt as a result of the judgment obtained by the liquidator. Our booklet on "Ten risks that directors face" deals with this subject in more detail.**

7 What is best practice for a director in the twilight zone?

The first thing a director has to decide is whether the company is likely to avoid liquidation and, if so, how it will avoid liquidation.

If an investment or other sales are expected shortly and this is a realistic belief, then this may be sufficient to disprove any allegation of wrongful trading. Ultimately, a director should sit back

and consider whether the decision being made appears to be reasonable bearing in mind his/her knowledge, experience and the circumstances that the company finds itself in.

It is not unusual for a director to be convinced of incoming investment or sales whereas an objective individual maybe in disagreement. For this reason it is wise to employ the service of a professional, particularly an accountant or a solicitor, to advise on these matters and consider whether the company should continue trading.

A professional's distance from the company (which may have further emotional ties with the director by reason of it being a family business or the individuals who he jointly set-up with) enables them to objectively consider whether a company should continue trading and, if so, which decisions are justifiable.

If the company has a business which is otherwise profitable then it may be that placing the company into administration and selling the business out of administration is the best course of action to protect the company's business, assets and the employees' rights. Alternatively, insolvency may be the worst thing for a company, which has the legitimate ability to trade its way out of the situation or refinance itself.

However, if there is no business capable of resale then it may be a case that the directors have to place the company into liquidation. If the company is losing money, the earlier the directors put the company into liquidation the lower the risk that they will be personally pursued for the losses occurring as a result of any delay or failure to wind up the company's affairs.

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