SMES, DIRECTORS & SHAREHOLDERS

10 risks that directors face

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INTRODUCTION

Directors of limited companies are under increasing pressure to be transparent and accountable for their actions. Recent legislation increases the personal risks that directors face both whilst a company trades and, more commonly, where it is placed into some type of insolvency proceeding.

Quite often companies fail because of new technologies, a change in demand, a change in fashions and trends, changes in regulations and laws or because of financial mismanagement. These factors are often beyond a director's control, particularly where s/he is one of several directors, some of whom may have different roles and responsibilities or more experience.

However, when it comes to accountability, the legal position rarely distinguishes between these subjective considerations and, generally, directors are judged according to a high threshold of expectation, which may comprise a responsibility for matters which, in reality, they have a limited ability to control.

Our booklets entitled "Breaches of a director's fiduciary duties" and "Directors in the twilight zone" address how a director should act generally and in circumstances where his/her conduct may be examined more closely at a later date.

Below we present some of the main risks that a director faces and we make some suggestions how to best mitigate such risks.

1 Prosecution for failing to file accounts or returns

Under the Companies Act 2006, all directors of a company can be subject to criminal proceedings for failing to file annual financial accounts and/or annual returns in accordance with the statutory deadlines. The requirements in respect of annual returns have changed slightly as a result of recent changes in the law, but the threat of prosecution remains.

These prosecutions are increasingly common and often lead to fines which can be quite serious for a small company.

Whilst the fee for filing such accounts and returns is approximately £25, a failure to comply with this duty can land a director with a personal liability of several thousand pounds in the criminal courts.

This will also mean that the director (or directors) will have a criminal record as a result of such proceedings and this may jeopardise the company's business, either directly in terms of the sector it engages in, or indirectly in terms of credit referencing etc.

2 Disqualification for consecutive prosecutions

As described by the last point, a director can be prosecuted in the criminal courts for a failure to deal with Companies House filings.

If a director does this in consecutive years, and is prosecuted on more than one occasion, then when bringing such proceedings the Registrar of companies may also cite the previous convictions in support of the charge and may additionally seek the director's disqualification for a period of between one to five years.

The disqualification order will not normally be made at the first hearing and the director will have an opportunity to attend or be represented at a further hearing. However, if the magistrates decide that disqualification is appropriate, then this may in some circumstances commence immediately.

A failure to immediately resign as a director and cease acting as a director may constitute a further criminal offence with far more serious penalties.

The effect of disqualification will have a serious effect on the ability of a director to maintain his/her livelihood, especially if the current company (including connected companies) are his/her sole source of income. The disqualification also prevents a director from participating in any way in the company and often directors who seek to manage a company as an "employee" can be subject to the criminal consequences of breaching a disqualification order (which are indictable and far more serious than the original offence).

Please see our booklet entitled "Prosecutions by Companies House" for more information on this subject.

3 Guarantee liabilities

It is not uncommon for a trading company, dependant on its business, to require financial support to promote growth into new areas or to expand its current business.

This can come as funding in various forms, including straightforward loans, more complicated banking facilities and/or loan facility agreements, which may be secured against the assets of the company.

Sometimes, dependent on the nature of a company's business, it may be appropriate to seek a bank facility which enables a drawdown of funds between raising an invoice and getting paid. This type of finance is known a factoring or invoice discounting (dependent on the services provided by the financier).

Regardless of the type of finance sought, many companies will have an uncertain credit record or no fixed assets and therefore this presents a risk to the finance provider. Accordingly, personal guarantees will often be sought from directors and sometimes even security over their own homes or any other personal property assets.

The effectiveness of these guarantees will depend on the circumstances they were entered into, but what cannot be ignored is that following the execution of any such guarantee then the prosperity of the directors is inextricably tied up with that of the company.

If the company fails or falls on hard times, then inevitably the bank may call in its security and thereafter the personal guarantee, which could result in a director losing their home and even, in a worst case scenario, being declared bankrupt.

4 Unfair prejudice claims

Under Section 994 of the Companies Act 2006 a shareholder can bring a claim against a co-shareholder for any loss (i.e. prejudice) they have suffered as a result of the other shareholder's actions.

This is commonly used in small to medium-sized companies where the shareholders and directors are similar groups of individual and where an imbalance develops, beyond what the original parties' "reasonable expectations" were.

An unfair prejudice claim is quite easily confused with a company claim by shareholders (usually referred to as a derivative claim – see below) and it must be remembered that an unfair prejudice claim is appropriate for claims for losses by a shareholder or specific group of shareholders. It cannot be used as a ground to commence proceedings brought for losses to the company as a whole, which is a matter for the company to deal with via its appointed directors.

Please see our booklet entitled "How to protect minority shareholder Interests" which provides more detail on these remedies in relation to minority shareholders.

It is not uncommon for a shareholder to petition for the just and equitable winding-up of a company and for this petition to be accompanied by an unfair prejudice petition. In these circumstances, it is possible that the court may order the company to buy that shareholder's shares (if they agree), or alternatively order that one shareholder (or group of shareholders) buys the others out.

5 Statutory derivative claims

A statutory derivative claimant (or "derivative claim") is brought by shareholders under Part 11 of the Companies Act 2006 in respect of one of the following circumstances:

1. **In respect of a cause of action vested in the company; or**
2. **Seeking relief on behalf of the company.**

Conventionally, where a shareholder or group of shareholders wish to deal with one or more directors or require that the directors ensure the company takes such proceedings, the majority rule of shareholders will ensure that such steps are taken within the terms of the company's articles of association, company law and any shareholders' agreement.

Shareholder resolutions can include the dismissal of a director (or more than one), the proposal to take certain legal proceedings, any relevant requirements to amend the company's articles of association and, if one exists, any shareholders agreement.

However, these powers are only normally exercisable by the majority of shareholders and where the majority and the minority are in disagreement, it is very common for the minority to feel discriminated against in respect of all decisions made by the company.

In such circumstances, minority shareholders can seek the court's assistance and, if they feel that either a director (past or present) or a third party should repay monies to the company or is otherwise liable to it, then the court if satisfied may support such a claim. Alternatively, such proceedings can be instituted to pursue a director who may have removed money or assets from the company (even one who is currently appointed).

Please see our booklets entitled "How to protect minority shareholder interests", "What happens when shareholders/directors fall out?" and "What can shareholders do to control directors?" for more information on this subject.

The applicant will usually present the claim against the directors and the company and there will be initial evidence and a hearing as to whether there is a strong case. If the claim succeeds at this stage, then the company may become the claimant and the shareholders who commenced the claim will be authorised to use company funds to continue the legal proceedings against the remaining defendant(s).

If such proceedings are successful, this can be extremely damaging to defendant directors and they will not only be liable for any losses claimed and accepted by the court, but they may also be liable for interest and legal costs personally.

6 Liability for breaches of fiduciary duties/misfeasance

A director holds a similar position to a trustee such that he owes a fiduciary duty of care and trust. This duty extends to the company itself, as a separate legal entity, its shareholders, employees and, in certain circumstances, its creditors.

Any breach of such duties whilst performing within his/her role as director and which causes any loss to an individual or category of individuals can make that director personally liable for such losses.

Whilst during the course of trading a claim for breach of fiduciary duties generally lies with the company (unless a different fiduciary relationship can be proven) after the company has been placed into liquidation proceedings can be brought on similar grounds, which is described as misfeasance.

The company and its creditors can take action against the director for any step s/he has taken which has caused a loss to the company and which may have been unreasonable or not a step which one would expect a director with the same skills and experience to have taken. See, for example, our booklet on "Directors in the twilight zone" which provides examples of these type of circumstances.

A misfeasance claim can include concealing financial information upon winding-up through to straight-forward theft of assets of the company, including circumstances where they are sold below their market value.

Even circumstances where company assets have been used for the benefit of third parties (e.g. paying off creditors) can be grounds for such losses to be repaid by directors as a result of such a claim.

7 Liabilities arising in insolvency

There are numerous types of transaction which may be subject to a claim by appointed liquidators and administrators over an insolvent company.

Quite often the transactions will be conventional debts due as shown in the company's books and records, but this does not preclude a review of the company's accounting records leading to claims for other sums. Such claims arise in the insolvency legislation, particularly the Insolvency Act 1986, and solely vest in the appointed liquidator or administrator (who also have the power to assign such claims).

Such claims in insolvency are usually made against the person or entity receiving the asset, for example a spouse or child of the director, as well as the director him/herself.

For example, if an asset has been transferred to a third party for nil or less than its market value, then such a claim can be brought against them for recovery of the difference and misfeasance proceedings issued against the perpetrator director for allowing the transaction to occur.

If a creditor has been paid his/her debt in the period leading up to insolvency, then it is not unusual for an appointed liquidator or administrator to seek repayment of that sum from them as a preference.

Quite often, the recipient of such transactions are the directors, their family members or friends. Accordingly, such recovery efforts do not usually go unnoticed by directors and indeed are often combined with claims against the directors themselves for misfeasance as described above.

Other post-insolvency claims can be made against directors including wrongful trading, fraudulent trading and transactions defrauding creditors.

These are all dependent on the circumstances that existed pre-insolvency and what decisions the director(s) made with regard to the company's ongoing trading, the jeopardy to customers and members of the public generally and the reasonableness of his/her actions.

Our booklet entitled "Directors in the twilight zone" better describes the circumstances and considerations that must be made by directors in respect of such risks.

8 Director disqualification

Once the company has been placed into an insolvency process, the official receiver or the nominated administrator or liquidator is required by law to make a report on the conduct of all directors in the period leading up to the commencement of the insolvency proceedings.

Such a report can be based upon the condition of the company's accounting records, the treatment of HM Revenue & Customs in the period leading up to liquidation, the treatment of any other specific creditors and the dealings with assets or finance arrangements.

There is a statutory list of the types of misconduct referable to disqualification but this list is not exhaustive and accordingly the types of behaviour that can be subject to such analysis is unlimited. The test is what a reasonable director, of that individual's skill and experience would do and the fairness of treatment to all of the company's creditors equally.

If a decision is made to commence disqualification proceedings against a director, initial steps will be taken to offer to the director an opportunity to enter into a disqualification undertaking (thus avoiding the legal costs which would otherwise be sought in court proceedings). The key for any director when dealing with such matters is to seek advice and assistance as soon as possible.

In such circumstances a director can be disqualified, either by undertaking or by court order, for a period of between 2-15 years. The more serious the allegations, the higher the period, with a period of 11-15 years being reserved to circumstances of fraud and criminal deception.

If a director is disqualified, this can ruin their career, with the disqualification being picked up by banks, credit reference agencies and, for high profile matters, the press.

For any directors who are qualified professionals (for example accountants, solicitors and finance professionals) this could mean the loss of their practising certificate and ultimately any opportunity to have a career thereafter.

9 Personal liability notices

Section 121C of the Social Security Administration Act 1992 provides HMRC with the powers to recover unpaid National Insurance Contributions, plus any interest and penalties, from the directors or other officers of the company.

"Other officers" include company secretaries, and therefore the extent of this liability extends beyond directors.

Unpaid National Insurance Contributions can be reclaimed from directors and company officers of both live trading companies and companies that have been placed into insolvency proceedings.

The statutory requirements provide that there must be both unpaid contributions and an element of culpability of the individual director.

Similar recovery powers exist in respect of PAYE contributions and upon issue of as personal liability notice a director (or company officer) will be liable to repay such proportion of the company's liability for PAYE/NiC contributions as is considered was unpaid as a result of the director's actions.

It must be remembered that this liability exists in respect of all employee contributions, and thus the severity of this penalty will depend on the amount of employees the company employed.

10 Compensation orders

From 26 March 2015 the Small Business Enterprise and Employment Act 2015 introduced changes to legislation such that, when directors are disqualified (either by court order or by way of a voluntary undertaking) there is a further two year limitation period during which proceedings can be brought against those same directors seeking compensation for the losses that are either proved or accepted to have been caused as a result of their misconduct.

These proceedings, if issued, may result in a compensation order being made against the director(s) in a sum of a similar amount to the shortfall between creditor claims and assets realised in a liquidation.

This undermines the main reason why directors sign disqualification undertakings, which is usually to avoid the legal costs of a disqualification claim being issued against them.

From the moment that regulations are introduced to enable compensation order proceedings to be issued, the costs incentive of signing a disqualification undertaking will disappear and the director would be best advised to contest such proceedings in almost all occasions.

This risk of a compensation order is particularly important for directors as a majority of all disqualifications, either by undertaking or by disqualification order, are as a result of the prejudicial treatment of HMRC and tax losses arising as a result.

The application for a compensation order by the Secretary of State could act to remedy the problem of lost tax revenues, to the detriment of company directors.

Compensation orders will also be available in other circumstances where directors are disqualified, for example in criminal proceedings. Accordingly, they could lead to a civil claim following the outcome of criminal proceedings, with the result that there is no let-up in legal proceedings brought against directors.

In summary, where the company has been placed into administration or liquidation, the compensation order legislation may mean that the consequences of insolvency could last as long as 5-7 years after the date the company is placed into administration or liquidation, even though the circumstances were not as a result of any criminal behaviour.

For more information on this subject, please see our separate dedicated booklet entitled "Compensation orders – the risk to directors – 10 frequently asked questions".

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