Directors' Duties Under English Law — How to Lead in Difficult Times

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Elon Musk recently said he has a "*super bad feeling*" about the economy, pithily declaring what most financial commentators have been predicting in more technical terms.

To the extent there is still time to batten down the hatches with equity markets tumbling, directors need to be prepared. Directors of companies facing financial difficulties may find themselves being pulled in different directions by different stakeholder interest groups. Activist investors are becoming more commonplace. Some may threaten to file for insolvency. Others may warn the board against a voluntary filing. There will be demands for the preservation of value. Meanwhile, at the back of the director's mind will be the spectre of personal liability if she or he missteps and loss is suffered.

With these conflicting pressures, how does a director avoid reactive behaviour?

Below are some helpful practical guidelines to provide some structure and foundation to decision-making and help a director lead with confidence.

Leading in the Face of Potential Personal Liability

Directors complying with their common law and Companies Act 2006 ("**Companies Act**") duties do not, in the ordinary course, face personal liability for corporate losses. For companies in financial difficulties, however, the Companies Act requires that directors turn their attention to creditors' interests, and the content of their duties will be assessed accordingly.

The Insolvency Act 1986 ("**Insolvency Act**") imposes potential personal liability on various grounds. The principal ground is if trading wrongfully continues and creditors suffer loss. In the depths of the Covid-19 pandemic, liability for "wrongful trading" was restricted, but the law has now reverted to its pre-Covid-19 position and directors need again to be mindful when trading "in the zone of insolvency."

There are other grounds for personal liability, in particular "misfeasance" under Section 212 of the Insolvency Act. A director may be personally liable during the course of the company's liquidation if it is found that she or he has acted in breach of fiduciary duty or misapplied company property, and thereby caused loss to the company. While "wrongful trading" was restricted during the Covid-19 pandemic, the government was at pains to remind directors that liability for misfeasance was still alive.

Wrongful Trading Liability (Under Section 214 and Section 246ZB of the Insolvency Act)

A refresher on "wrongful trading" liability is a good foundation for setting the parameters of good decision-making.

The law states that a director may be required to compensate creditors where the company has gone into insolvent liquidation or administration and where:

- from some point in time before it did, she or he knew or ought to have concluded that there was no reasonable prospect of the company avoiding that fate ("**Relevant Time**");

- allowed the company to continue to trade; and
- did not from the Relevant Time take every step available to minimise the potential loss to creditors.

Dishonesty is not required.

Liability is the *net shortfall* suffered by the general body of creditors, from the Relevant Time up to the point of an insolvency filing, as a consequence of continuing trading. While this suggests that loss suffered by a specific creditor is not relevant, the defence of taking every step to minimise the potential loss to creditors may not be available if loss, or disproportionate loss, has been caused to an individual creditor(s). This may mean, for example, that if a pre-existing financier has been paid, but unpaid debts have been incurred to a new financier, depending on the circumstances, the defence may not be available.

Whether a director "*knew or ought to have concluded*" involves both objective and subjective factors. The action is taken by the administrator or liquidator for the general body of unsecured creditors.

When resignation seems like the only palatable option, bear in mind that it is not a defence to have resigned from the company once difficulties have arisen.

Seek Expert Advice and Plan Ahead

This may seem like an avoidable expense, but hiring specialist advisors early on will be necessary and will assist in mounting a defence if losses are suffered. The courts have repeatedly driven home this point. The sooner difficulties are confronted and advice sought, the longer the runway to explore options will be. Left too late, an insolvency filing may be all but inevitable.

Know Your Finance Agreements and Other Contractual Commitments

Whether to carry on trading requires continuous exercise of judgment, weighing of the facts, and balancing the various options and potential outcomes.

Knowing salient details of the company's credit facilities will help put decision-making on solid ground and facilitate planning. The following information should be at the director's fingertips:

- When are the maturity dates?
- When are the dates for paying interest and amortisation of principal?
- Are there any financial covenants? When are covenants tested?
- Are other events of default looming?
- Should lenders be approached with a view to negotiating waivers?

Know Your Valuation and Balance Sheet

Up-to-date financial information must be at hand. Directors should know the liquidity runway and valuation, since both are fundamental to cash flow and balance sheet solvency. This should be known on a current basis, six months and twelve months forward, in each case, given a range of realistic assumptions. This is also important as, save for where there is a clear event demarking the Relevant Time (for example, the loss of a key contract), the Relevant Time will generally be determined by a retrospective analysis of financials and a reconstruction of the balance sheet over time.

Hold Regular Board Meetings and Keep Detailed Minutes

Board meetings should be conducted with the components of "wrongful trading" and other grounds of liability borne in mind. Well-run board meetings, properly minuted, will be invaluable in mounting a defence.

Minutes must evidence the options considered and discussed as well as the decisions made. They must narrate the board's reasoning.

It would be prudent to discuss liquidity at every meeting. A decision to continue trading must be explained and justified. Any decision to incur new indebtedness should be made following receipt of specialist advice and after answering the question of whether it will provide more runway to trade out of difficulties or whether, viewed objectively, it is simply "hope value", resulting in increasing liabilities with no tangible benefit.

Company-by-Company vs. Group Companies

Directors must remember that the law views each company on an individual basis, not as a group: liability is determined on a per-company basis. Each company's balance sheet is individual to itself.

Contingency Planning

Depending on resources, a special committee should be assigned to explore the options available. For companies with a large capital structure, a compromise of a class or classes of creditors may be viable by way of a Scheme of Arrangement or Restructuring Plan under Part 26 or Part 26A of the Companies Act, or a Company Voluntary Arrangement under the Insolvency Act. For smaller companies, the cost of these processes may be prohibitive, in which case bilateral negotiations will need to be conducted. The downside case will be an administration (with or without a pre-pack sale) or liquidation. Timing of appointing an insolvency practitioner to conduct an accelerated M&A process should be considered.

Treatment of Stakeholder Classes

The general body of unsecured creditors should be treated equally, reflecting *pari passu* treatment of creditors in an insolvency process. However, circumstances may arise where paying some but not other creditors is necessary. For example, while exploring viable longer term options, it may be that essential suppliers and employees must be paid their contractual entitlements at the expense of others.

In complex capital structures, where intercreditor arrangements apply, directors often turn their focus to those creditors falling above the water line – where the "value breaks" – since this will be the point of reference for preserving value. However, case law for directors' liability does not seem to have caught up with this practical reality. The law still focuses on the general body of unsecured creditors being treated equally.

Duties to Members vs. Creditors

In addition to liability for "wrongful trading" under the Insolvency Act, there may also be liability for breach of duty under Section 172(3) of the Companies Act. When a director knows or should know that the company is "likely" to become insolvent, the focus of attention should shift from the members to the general body of unsecured creditors, and compliance with the duties will be assessed accordingly. "Likely" in this context has most recently been held by the UK Court of Appeal to mean "probable." However, the question of the precise point at which the duty to consider creditors' interests is engaged – either where there is a real risk of insolvency, or a probability of or close proximity to insolvency – has been the subject of an appeal to the UK Supreme Court. The decision is awaited. We also await clarity from the courts on whether from that point creditors' interests are paramount or are to be considered without being decisive.

Nominee Directors

In times of financial difficulty, when pressure is at its greatest, directors are invariably pulled in different directions, with some stakeholders encouraging a more, or less, risk-averse approach. Some stakeholders will want to withdraw support, while others will want the business salvaged, come what may.

Pressure is often brought to bear most when a director has been appointed by a sponsor or specific creditor. It would not be unreasonable to require the nominee to indemnify against liability. It is *especially* at times of financial difficulty that conflicts of interest must be avoided. First and foremost, focus must be to the general body of unsecured creditors.

At board meetings, nominee directors should highlight any position asked to be taken by their investor or sponsor and ensure the board minutes narrate this disclosure. In this way, allegations of conflicts of interest can be minimised.

Shareholders

Liability may arise if shareholder loans are repaid, or dividends declared, in circumstances where payment would distribute the company's assets at the expense of creditors.

Payment of a dividend may also fall within the scope of a "transaction defrauding creditors" under Section 423 of the Insolvency Act and meet with personal liability for directors.

Unlike liability for "wrongful trading", liability under s.423 does not require that the company be in a formal insolvency process. A victim (i.e., a person who is, or is capable of being, prejudiced by the transaction) may initiate the action. Liability under s.423 requires that the transaction was done *for the purpose* of putting assets beyond the reach of creditors or otherwise prejudicing creditors' interests. Whether the purpose is one of the offending purposes is a subjective test and essentially a question of fact.

Some Common Issues

Refinancing and New Money

As mentioned above, care needs to be taken when borrowing from a new creditor to repay an existing creditor, especially when more indebtedness is taken on than previously. Depending on the purpose for which the new liability is being incurred, if the director knows the company cannot repay, there is a risk of straying into fraudulent trading under Section 213 of the Insolvency Act.

Although not always practicable, it should be considered whether it is possible to combine the incurrence of new indebtedness with negotiating a compromise with other creditors, in order to spread the risk amongst all stakeholders.

In sizeable capital structures, repaying existing lenders with new money is often done in the context of a formal restructuring, by way of lock-up agreements, where the new money is subject to a broad-based compromise and restructuring of the balance sheet, as well as other conditions.

Sale of Assets

In the quest for liquidity, selling assets might be considered. However, care must be taken to ensure that not less than market value is achieved, since this may constitute entering into a transaction at an undervalue and/or misfeasance, with the legal consequences that follow. The "misfeasance" provisions mentioned above provide not so much a new cause of action against a director, but rather permit a summary procedure for litigation against a director for breach of fiduciary duty.

This risk is often why a so-called "pre-pack" is considered, where the sale is negotiated with the assistance of a licensed insolvency practitioner, who is then appointed as administrator to execute the sale. Directors avoid liability by using the insolvency practitioner's cloak of statutory authority.

Granting Security

Existing creditors sometimes apply pressure for more security. Acceding to such a request may not be advisable. The law on this area is beyond the scope of this article. Suffice to say, by way of example, a floating charge is susceptible to invalidation if created for the benefit of a connected person within two years of insolvency or an unconnected person within one year of insolvency.

Listed Companies

Directors of listed companies must bear additional considerations in mind, such as the obligation to disclose financial difficulties to the market and to call a general meeting if the net assets fall below a specified percentage of the called-up share capital. The details of these obligations are technical and beyond the scope of this article.

Summary

There is no denying that navigating this area is complex. The Court of Appeal rather sympathetically referred to it recently as involving "*very difficult policy issues*", recognising the "*very significant practical consequences for the conduct of business*", and that determination of the issues involved "*a difficult amalgam of principle, policy, precedent and pragmatism.*"

Preparation and steadfastness is required. Good advice is essential.

CONTACTS

For more information, please contact your Katten attorney or any of the following:

Sonya Van de Graaff
+44 (0) 20 7770 5221
sonya.vandegraaff@katten.co.uk

Prav Reddy
+44 (0) 20 7770 5213
prav.reddy@katten.co.uk

Mark Johnson
+44 (0) 20 7770 5214
mark.johnson@katten.co.uk

Katten katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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