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DIRECTORS DUTIES DURING DETERIORATING TRADE

In the current economic climate, it is more important than ever that company directors are aware of their duties in relation to the running of the company, so that they do not run the risk of committing an offence or incurring personal liability.

Directors act as agent and trustee for the company and its property. A director is accountable for his actions and therefore owes certain duties to the company. Over the years these duties have evolved through the courts, but these have now been largely codified in the Companies Act 2006. Such duties include the duty to act within powers, to promote the success of the company, to exercise independent judgement, to exercise reasonable skill, care and diligence, to avoid conflicts of interest, and not to accept benefits from third parties.

Where a company is solvent, the directors owe their duties to the company and it is the company, acting by its shareholders, which has the right to enforce these duties. The company's interests are aligned with those of the present and future shareholders. Where a company becomes or is likely to become insolvent, this position changes.

Although the duties are still owed to the company, the interests of the creditors become paramount and the company (its business and assets), should be managed in order to protect their interests. If a formal insolvency procedure follows it will be the administrator or liquidator who can be expected to pursue the company's rights of action.

Directors are at risk of incurring personal liability where they breach their duties or if, during the winding up of a company, they are found to have been guilty of wrongful or fraudulent trading under the insolvency legislation by their conduct prior to the liquidation.

Wrongful trading occurs where a company has gone into insolvent liquidation and at some point before this, the directors knew, or ought to have known, that such liquidation could not be avoided, but yet continued to trade the company and make the situation worse.

Wrongful trading is difficult to determine, especially in uncertain financial climates, as directors may continue trading with the hope that the situation will improve. In order to avoid liability for wrongful trading a director must show that after he knew or ought to have known that insolvency was unavoidable, he took every step he should have to minimise the potential loss to creditors. The steps which a director ought to have taken are judged on the basis of what a 'reasonable director' would do in the same circumstances. A 'reasonable director' is a director who is a reasonably diligent person having both the general knowledge, skill and experience reasonably expected of a person carrying out the same functions as are carried out by the particular director concerned, and also the general knowledge, skill and experience of the actual director concerned.

If it can be shown that any business of the company has been carried on with the intention of defrauding the creditors, the directors who were knowingly involved in such action could find themselves guilty of fraudulent trading. In such circumstance the court can require the directors involved to make a personal contribution to the company's assets.

Directors should also ensure that good value is obtained for any property or assets that are to be disposed of by the company. Gifts and transactions at a substantial undervalue may be challenged by a subsequently appointed administrator or liquidator, and a director's involvement in such arrangements will be critically examined. The same applies to conduct that later results in a creditor or guarantor's

position being improved in a liquidation at the expense of other creditors. Paying off a company debt because it will reduce a personal liability of a director to the same creditor is a good example. Not only may such 'preferences' be reversed by the court later, but a director may be made accountable for their involvement and find themselves having to make good any loss to the general body of creditors.

Directors should also bear in mind that if there is an administration or liquidation of the company, the administrator or liquidator has a duty to report to the government on the conduct of directors in the period leading up to the liquidation or administration. If their conclusion is that the director has acted in a way that is unacceptable for someone holding the office of director, then proceedings for that person's disqualification may follow.

In order to protect themselves from potential exposure to any of the above claims, it is important that, where a company is experiencing financial difficulty, regular and frequent board meetings are convened where accurate and up to date financial information is available to all directors so that informed commercial decisions can be made. It is crucial for all such meetings to be carefully minuted so that there is a paper trail in place that the directors can point to in the event their conduct is questioned. Where directors find themselves running a company which is in financial difficulty, they should seek external advice from an insolvency lawyer or licensed insolvency practitioner as soon as possible. This is not only in order to protect the interests of the company, but also to reduce the risk of incurring personal liability. Taking and acting on advice from a professional may provide a useful defence to such claims as wrongful trading.

Simon Biggin

Partner
Cambridge
01223 461155
simonbiggin@hewitsons.com

Dominic Hopkins

Partner
Northampton
01604 233233
dominichopkins@hewitsons.com

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