PROTECTING DIRECTORS OF COMPANIES THAT ARE INSOLVENT OR IN THE ZONE OF INSOLVENCY: IMPORTANT CONSIDERATIONS AND PRACTICAL SOLUTIONS

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Following the recent economic slowdown suffered globally and particularly in the Eurozone, many of the UK companies now face serious financial challenges. Directors of companies constantly undergo mounting pressure to fix their solvency crisis quickly by selling off assets, restructuring debts or instituting radically new corporate strategies. While doing so, directors must tread carefully when making these decisions, as they can serve as a basis of lawsuits claiming breach of fiduciary duties or of other claims based upon laws relating to fraudulent trading or payment of illegal dividends. Directors are especially vulnerable as they are susceptible to be scrutinised and questioned by the courts, creditors and shareholders who have the benefit of a 20/20 hindsight. Further, directors of insolvent or near insolvent companies may be tempted to enhance the company's short term liquidity by failing to make the requisite payments, which may expose them to personal liability, such as payments which arise under tax and environment statutes.

This article discusses the fiduciary duties owed by directors of companies which are either insolvent or in the zone of insolvency as well as the method by which courts determine a company's solvency. The article further provides suggestions for action that directors may take to limit their personal exposure to liability in managing their companies.

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In recent years, particularly since the global financial crisis, corporate governance and directors' duties have become issues of increasing prominence. Governments around the world have introduced various laws and devices to handle these issues. In this respect, the British Government's stimulus package, including the public bailout of some of its largest banks has not created greater public interest in how directors consider and control corporate risk. In early 2009, the former Prime Minister, Gordon Brown commissioned David Walker to examine corporate governance procedures in the UK's banking industry and the final recommendations were published in November 2009 in the Walker Report.[1] The Report contains recommendations regarding corporate governance matters including the size, composition and qualification of a Board of Directors and its members, their functions and governance of risk. Although the Report was commissioned to analyse the corporate governance of financial institutions, many of its findings and recommendations are transferable to corporate entities outside the financial sector.

The laws of the UK provide certain bright-line rules with respect to directors' conduct, including requiring directors to promote and protect the best interest of the company at all times. In promoting shareholder interests, directors must take into account a range of factors affecting the company's relationships and performance, in order to maximise the value of the corporation. It recognises that when a company is solvent, it is the shareholders who are the primary stakeholders and beneficiaries of the fiduciary duties imposed on directors. The proprietary interests of shareholders entitle them as a general body to be regarded as the company when the questions of the duty of directors arise. As insolvency intrudes, however, the interests of the creditors will rise to the forefront. In this context, actions of directors that benefit the company, enhances the interest of the company's economic stakeholders, whether they are creditors or shareholders. Depending on the company's state of solvency, either shareholders or creditors will have the power to pursue remedies for the benefit of the company when a director

[1] *A review of corporate governance in UK banks and other financial industry entities* (Final recommendations, 26 November 2009).

has breached his fiduciary duties. Therefore, determining whether a director owes a duty to creditors and when this duty arises is crucial in determining whether a director has committed a breach which may impose on him a personal liability.

Do Directors owe a duty to creditors and when?

At common law, it is well established that directors of a company owe a fiduciary duty to act bona fide in what they consider to be in the interests of the company.[2] This duty is regarded as an integral part or even the broad basis of directors' fiduciary duties. Directors are required by law to make reasonable decisions and take appropriate actions to promote and protect the best interest of the company at all times. Strictly speaking, this means that directors, when required to act in the best interest of 'the company', are under no obligation to act in the interests of individual shareholders or creditors.[3] However, the fact that directors have to act in the best interests of the company does not, however, mean that they have to promote the welfare of the artificial entity, as it would be impossible to give a definite content of a duty framed in terms of benefiting the entity itself. In other words, the requirement to benefit an artificial entity, as an end in itself, would be irrational and futile, since a non-real entity is incapable of experiencing well-being. Gower recognises the problem of treating a metaphysical entity as the beneficiary of directors' duties.[4] Hence, the corporate entity is regarded as a vehicle for benefiting the interests of a specified group or groups. If this is the case, then the vexing question still is who represents the 'specified group or groups' for whose best interest the director is required to act.

[2] *Re Smith & Fawcett* [1942] Ch 304, 306 (Lord Greene MR) 306.

[3] This well-known principle was reaffirmed by Dillon LJ in *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563 at 585, where he left no room for doubt, stating that - 'directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders'.

[4] Davies Gower, *Davies' Principles of Modern Company Law* (Thomson 2003) 371.

For many years, it was generally accepted that the 'company as a whole' refers to the body of shareholders, which meant that directors, when required to act in the best interest of the company, actually had to consider the best interest of the shareholders of the company.[5] The company was always equated with its collective membership, which traditionally was understood to comprise the general body of shareholders. However, 'interest' was later redefined and extended to creditors as one of the constituencies in the company by the courts.[6] The company thus remains the beneficiary of the directors' duties. Directors can therefore become liable based on the fact that they did not act bona fide in the best interest of the company because they neglected to consider or protect creditors' interest. The UK courts in *Lonrho Ltd v Shell Petroleum Co Ltd,*[7] Lord Diplock, referring to the interests of the company, stated that the best interests of the company 'are not necessarily those of the shareholders but may include those of the creditors'. This viewpoint was endorsed by an obiter remark by Buckley LJ, while delivering the primary judgment in *Re Horsley & Weight Ltd,*[8] namely that it may be 'somewhat loosely said that the directors owe an indirect duty to creditors…but I would regard it as more accurate to say that the directors owe a duty to the company'. In *Yukong Line Ltd v Rendsburg Investments,*[9] Toulson J was clear on the point that a director 'does not owe a direct fiduciary duty towards an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company'. Also in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse)*

[5] This viewpoint came across very clearly in *Greenhalgh v Arderne Cinemas Ltd,* where the court stated that 'the company as a whole', does not...mean the company as a commercial entity, distinct from the corporators. It means the corporators as a general body; as well as *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563, 585, where a similar statement was qualified with reference to the company's financial position. The court expressed the view that so long as the company is solvent the shareholders are in substance the company.

[6] See *Parke v The Daily News Ltd* [1962] Ch 927, 943; *Greenhalgh v Arderne Cinemas Ltd* [1951] 1 Ch 286, 290.

[7] [1980] 1 WLR 627, 634.

[8] [1982] 3 All ER 1045, 1055.

[9] [1988] 2 BCLC 485, 503.

Ltd,[10] the court held that directors must act in the best interests of the company, which includes considering the interests of the company's creditors, should there be a possibility of imminent insolvency.

An issue faced by courts when dealing with directors' duties to creditors is determining the point in time when this duty arises. The courts in England seem to agree that a company must be experiencing some form of financial difficulty before a duty to creditors will be recognised. In other words, the duty may arise when the company is insolvent or of doubtful solvency.

When a company is solvent, the company's interest is represented by the interest of its shareholders, it follows that directors must act in such a way to promote the best interest and maximise value for its shareholders.[11] Creditors of a solvent company, on the other hand, can only expect the protection for which they had bargained when they entered into their transactions with the company. In *Winkworth v Edward Baron Development Company Ltd.,*[12] Lord Templeman clearly explained that:

> …a company owes a duty to its creditors, present and future...The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.[13]

[10] [2003] 2 BCLC 153.

[11] *Re Smith and Fawcett* [1942] Ch 304 (CA).

[12] [1986] 1 WLR 1512.

[13] See also Nourse LJ in *Brady v Brady* [1988] BCLC 579, who stated that 'the integrity of a company's assets (…) must be preserved for the benefit of all those who are interested in them, most pertinently its creditors'.

However, when a company becomes insolvent, it is then appropriate for directors to explicitly consider the interests of the creditors over those of the shareholders. This position was succinctly clarified by Street CJ in *Kinsela v Russell Kinsela Pty Ltd*[14] in the following manner:

> In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise…But where a company is insolvent the interests of creditors intrudes. They become prospectively entitled, through the mechanism of liquidation, to displace the power as the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.

The above was approved by Dillon LJ in *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250, over three decades ago.

Where the company is not yet insolvent, but is rather in the 'zone of insolvency' or 'in the vicinity of insolvency' it seems that the law is settled that directors do owe their fiduciary duties to creditors. The importance of the financial state of affairs of a company in determining whether creditors are protected by directors' duties to them was clearly enunciated in *Brady v Brady*.[15] The House of Lords, in commenting on the Court of Appeal's decision that financial assistance was not in the interest of the company because there was no evidence that the interest of the company's creditors had been considered, was very clear on the point that the proposal should not fail on that ground, as the companies were clearly

[14] (1986) 4 NSWLR 72.
[15] [1988] BCLC 579.

solvent at the relevant time. In two more recent cases, *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*[16] and *Miller v Bain*,[17] the court also linked the fact that directors have to consider the interests of creditors in discharging their duties to the company to the possibility of imminent insolvency, or insolvency.

However, it is unclear whether the fiduciary duties of directors in companies in the zone of insolvency shift *completely* to creditors, or whether such duties continue to be owed to shareholders as well. What is clear is that there will be a gradual shift of interest from the interest of the shareholders to favour the interest of the company's creditors.[18] The reason for the shift in fiduciary duties is that interests of shareholders are subordinate to the claims of creditors. Creditors of an insolvent company have an immediate interest in the value of the company's assets, because it is from these assets that their claims will be paid. Shareholders will no longer have a valuable interest in these assets. The shift in fiduciary duties is applied to ensure that the asset value of an insolvent company is preserved for creditors, who are the parties for whom the company's assets most matter.[19]

Another interesting question to consider at this juncture is whether director should continue to trade even when the company is insolvent or nearly insolvent? It may be that in the case of an insolvent company, its shareholders would prefer that directors take the corporate assets and use them in extremely risky ventures that may have a high probability of failure, but hold even the smallest possibility of astounding success. If the gamble succeeds, the shareholders will gain a profitable return on the investment. However, if the ventures fail, the shareholders lose nothing and creditors lose the value of the bet. The rationale behind this is that upon the insolvent liquidation of a company, the equity value is certainly nil and therefore, it is only the creditors who will have an interest in and receive a return on the assets of the company. It appears that the greater the risk of insolvency, the

[16] [2003] BCC 885.
[17] [2002] BC 899.
[18] See *Liquidator of West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250.
[19] (n 12).

greater the weight that must be afforded to the interests of creditors. In the case of *Re Hawkes Hill Publishing Co Ltd* (in liquidation),[20] Lewison J, having reviewed other cases[21] on this issue, said that there is no duty on directors to ensure that their company does not trade while insolvent. He added that:

> The question is not whether the directors knew or ought to have known that the company was insolvent. The question is whether they knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation.

Hence, English law states, that the mere fact that the company's shareholders have approved certain actions by the directors during a time of financial uncertainty will not of itself absolve the directors from liability for breach of their fiduciary duties. This point is best explained by Street CJ of the New South Wales Supreme Court in *Kinsella v Russell Kinsella Pty* [22] where he opined:

> It is to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interest of shareholders, the shareholders can either authorise that breach in prospect or ratify it in retrospect. Where however, the interest at risk are those of the creditors, I see no reason in law or logic to recognise that the shareholders can authorise the breach. Once it is accepted, as in my view, it must be, that the director's duty to the company, as a whole extends in an insolvency content not to prejudicing the interest of the creditors...the shareholders do not have the power or authority to absolve the directors from that breach.

[20] [2007] BCC 937.
[21] *Re Continental Assurance Company Ltd of London plc.* [2007] 2 BCLC 287; *Roberts v Frohlich & Anor* [2011] EWHC 257 (Ch); *Singla v Hedman & Ors* [2010] EWHC 902 (Ch); *Re Brian Pierson (Contractors) Ltd* [1999] BCC 26.
[22] (1986) 4 NSWLR 722.

In *Re Purpoint*,[23] it was held that a director who commenced management of an unsuccessful company did not contravene section 214 of the Insolvency Act 1986 by failing to put it into insolvency straight away, as to do so 'would impose too high a test'. Vinelott J said that he had some doubts as to whether a reasonable director would have permitted the company to have commenced trading at all because of critical factors such as a lack of a capital base and the only assets that the company had were purchased from borrowings or acquired on hire purchase.[24] Yet his Lordship did not hold that the respondent director ought to have concluded that the company was doomed from the outset. The conclusion that can be drawn here, as indicated above, is that the judges have carefully assessed detailed and rather complex testimony, and the judgments demonstrate an appreciation of many of the business issues encountered by directors.

Thus, when a company is in the state of insolvency, the law protects directors relying upon advice of professionals and acting in accordance with the established procedures and at the same time, empowers the company or its liquidator to exercise certain remedies against directors found to have breached their duties to the company. One such remedy is an action for 'wrongful trading'[25] which essentially attaches personal liability to a director of a failed company where such director knew or ought to have known, that the company had no reasonable prospect of avoiding insolvent liquidation and the director did not then take every step to minimise the losses to the company's creditors. If the director commits wrongful trading, he may be made personally liable for any losses incurred by the company, so as to increase the assets available to satisfy the creditors. Additionally, when a company is liquidated, the law also enables the disqualification of a director who has breached his duties.[26] As the law establishes a demanding standard for performance and a spectrum of penalties for a defaulting director of a distressed company, it is submitted that there can be a greater incentive for the directors of

[23] [1991] BCC 121.
[24] ibid 127.
[25] See section 214 Insolvency Act 1986.
[26] See sections 6 and 10 Company Directors Disqualification Act 1986.

financially distressed companies to actively follow creditors' interests, even if the proposed action might obviate the need for formal insolvency proceedings. Creditors of a solvent company may also rely on actions claiming fraudulent and wrongful trading and cannot rely on the obligations imposed on a fiduciary.[27]

It is however, questionable whether directors may also face actions brought by shareholders if the company grants creditors more rights than those for which they had bargained. Section 172(1) of the Companies Act 2006 requires directors to make decisions for the long term benefit of the members as a whole. The section provides that it is for directors to make decisions, in good faith, as to how to promote the success of the members as a whole. Section 172(1), when read together with section 170, makes it clear that the duty imposed on a director is to consider the interests of persons other than the company (including creditors) although he does not owe a duty directly to those persons but to the company alone. As an important consideration, it is strange that the term 'creditor' does not even appear in the list of factors contained in section 172(1) Companies Act 2006, although some of the categories listed such as employees, suppliers and customers may indeed be creditors. However, by virtue of section 172(3), the duty imposed by section 172 is subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. Consequently, it has from time to time been observed by judges that:

> ...when a company - whether technically insolvent or not - is in financial difficulties to the extent that its creditors are at risk, the duties which the directors owe to the company are extended so as to

[27] In *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187, Lord Templeman was a member of the Judicial Committee of the Privy Council which stated that: 'A director does not by reason only of his position as director owe any duty to creditors or to trustees for creditors of the company.' This seems to dispose of the possibility of creditors of a company taking action against its directors. This was confirmed in *Yukong Line Ltd v Rendsburgh Investment Corporation* (No. 2) [1998] 1 WLR 294.

> encompass the interests of the company's creditors as a whole, as well as those of the shareholders'.[28]

Determining the solvency of the company

Knowing the state of solvency of a company is fundamental for determining to whom its directors owe their fiduciary duties and when to commence winding-up proceedings. If the company is solvent, its directors owe their fiduciary duties to the company, its shareholders and others.[29] By contrast, if the company is insolvent or is nearly insolvent, directors may face future actions by the company's creditors alleging a breach of fiduciary duties. This shift of fiduciary duties to creditors from shareholders occurs when insolvency sets in, even if the corporation has not commenced a winding-up proceeding. In this respect, the practical problem that most directors will face is that the company may not clearly be insolvent, but may be moving in and out of insolvency. Accordingly, the timing for the decision to pursue the interest of creditors is crucial, especially when the company is in the zone of insolvency. Directors must therefore exercise reasonable care and diligence[30] to acquire and maintain sufficient knowledge of the company's financial position so as to be able to identify when there is a risk of insolvency occurring. In this respect, it is submitted that it should be established whether the company is doubtfully insolvent, in other words, whether there is reasonable expectation of insolvency that may result in the company being wound up, should that be the case, the duty of the directors will be triggered.

Customarily, the court utilises two distinct tests to determine the insolvency of a company. The first is called the "balance sheet" test[31] and the second is called

[28] Park J in *Re MDA Investment Management* [2003] EWHC 2277, [2004] 1 BCLC 217, 70.
[29] See section 172(1) Companies Act 2006.
[30] ibid section 124.
[31] Also referred to as the factual insolvency or bankruptcy test.

the "cash flow" test.[32] It is unclear whether the company would have to be found insolvent under both tests in order for fiduciary duties to shift to creditors, or whether the company being insolvent under only one test would suffice. There is some support for the proposition that the fiduciary duties of a company's directors shifts if the company is insolvent under either tests. However, the method of computing assets and liabilities depend on computing practice. These practices may legitimately vary. Nevertheless, the law generally requires that accounting for assets and liabilities must represent a true and fair view of the company's finances.

According to the balance sheet test, a company will be insolvent if the value of its assets is less than the amount of its liabilities.[33] Essentially, it inquires whether the fair value[34] of the company's liabilities exceeds the fair market value of its assets. This test requires the company to assign a fair market value to its assets and estimate the amounts that it will ultimately be required to pay on account of contingent liabilities. Fair value can be assigned if the assets are liquidated with reasonable promptness in an arm's length transaction in an existing and not theoretical market.[35] In assessing the marketability of the company's assets, it is critical for directors to consider contingent liabilities which may be related to the assets, the time frame in which they may be required to sell the assets or businesses, the state of the current and future market for the company's assets or business and whether there is in fact any potential buyers for the asset.[36] The balance sheet test

[32] Also referred to as the commercial insolvency or equitable insolvency test.
[33] Section 123 (2) Insolvency Act 1986
[34] Sections 393 and 464 Companies Act 2006 requires that that accounting for assets and liabilities must represent the true and fair view of the company's finances. In this respect, FRS 26 applies to listed and unlisted entities whose financial statements are prepared in accordance with the fair value accounting rules set out in Companies Act 2006. See also Practice Direction 11.8.7 Practice Direction- Insolvency at <http://www.justice.gov.uk/courts/procedure-rules/civil/rules/insolvency_pd> accessed 23 December 2012.
[35] ibid.
[36] ibid.

expressly requires that the court take into consideration the company's contingent and prospective liabilities.[37]

In determining the contingent liabilities, a director must consider the potential losses pending or anticipated litigation, or the risk that the corporation may be held accountable for the liabilities of a related company under "veil-extending"[38] or "alter ego" theories. Generally, the value of a particular contingent liability can be calculated by determining the potential size of the liability, and adjusting the amount of the liability to account for the probability that the contingency will materialise. Nourse J in *Re A Company*,[39] aptly explains contingent liability in the following manner:

> ...That cannot mean that I must simply add them up and strike a balance against assets in regards to prospective liabilities. I must principally consider whether and if so, when, they are likely to become present liabilities.

Professor Goode states that 'the question to be asked is whether there is a real prospect that the contingent will occur'.[40] This method will help directors establish a reasonable estimate of the company's contingent liabilities, and will help them determine the circumstances under which the company might be viewed to be insolvent after such liabilities are taken into account.

The cash flow test, on the other hand, focuses on a company's ability to produce sufficient cash (which can be derived from either continuing operations, disposition of assets or other capital raising activities) for the payments of debts as

[37] ibid.
[38] See S Ottolenghi, 'From Peeping Behind the Corporate Veil to Ignoring it Completely' (1990) 53(3) Modern LR 338.
[39] [1986] BCLC 261, 263.
[40] Roy Goode, Principles of Corporate Insolvency Law (3rd edn, Sweet and Maxwell 2005) 118.

they mature. The test is set out in section 123(1) of the Insolvency Act 1986 and the company is deemed to be insolvent when the company is not able to pay its debts as it falls due. This is a question of fact to be determined on the balance of probabilities. Even if a company is solvent under the balance sheet test, it may be insolvent in the cash flow sense if it lacks liquidity and the ability to generate sufficient cash. In determining the solvency of the corporation under the cash flow test, directors should account for things such as the company's recent and probable future operating performance, the liquidity of its assets, the value of deferred assets, impending maturities on its debt, the value of contingent liabilities, and its ability to comply with its loan agreements to draw on its credit facilities. It is clear from the cases that when determining solvency based on the cash flow test, the courts look at the financial position of the company in its entirety. In *Re Cheyne Finance plc (in receivership)*,[41] Briggs J clarified that there is some element of futurity in applying the cash flow position of a company and therefore solvency of a company should not be determined by focussing solely on debts due as at a relevant date. In *Re Taylor's Industrial Flooring Ltd*,[42] the company was held to be 'unable to pay its debts' under the Insolvency Act because it failed the "cash flow" test, notwithstanding the fact its liabilities did not exceed its assets.

It appears that there is a futurity aspect to the "balance sheet" test as with the "cash flow" test. As such, courts may judge in hindsight whether the company was insolvent at the time that the corporate decision in question was made, notwithstanding contrary presentations made in the company's audited financial statement and made to its Board of Directors. In addition to the concept of insolvency, market practice often refers to what is known as the "twilight zone".[43] This is not necessarily a time where a company may be considered technically insolvent on a cash flow or balance sheet basis, but it is during this time,

[41] [2008] 2 All ER 987.
[42] [1990] BCC 44.
[43] There is no legal definition of the term 'twilight zone' which is now widely used in the corporate insolvency to describe a period of trading when a company has, or is predicted to have, insufficient cash to pay its debts as they fall due.

transactions entered into by a company are still vulnerable to attack and may give rise to personal liabilities on the part of the directors. In the light of the somewhat broad tests of insolvency under English law and the risk of liabilities during the "twilight zone", it is crucial that directors keep accurate management information - in this respect, the financial position of the company under review.

Consequences of breach

A breach of a director's duty may give rise to a claim against that director either by the company or on behalf of the company only. If the company has been dissolved, the liability of that company's director is extinguished, unless the dissolution is set aside by the court.[44] A director who has breached his duties maybe liable to reimburse the company for any loss suffered by that company and in liquidation, any amount recovered by a liquidator will be held on trust for the benefit of the company's creditors as a whole.[45]

The consequences of a breach of sections 171 to 177 of the Companies Act 2006 are the same as those that apply where the corresponding common law rule or equitable principles applies.[46] This includes, but is not limited to damages or compensation[47] or a requirement that the director accounts for any profit[48] made as a result of the breach of his duties. The general duties, with the exception of section 174 of the Companies Act 2006, are enforceable in the same way as any other fiduciary duty owed to a company by its directors.[49] As these duties are owed to the

[44] Section 1029 Companies Act 2006.
[45] See *Re Prestige Grinding Ltd* [2006] BCC 421 where it was held that each unpaid creditor has a direct right of action and is entitled to retain the proceeds for himself, the right of action is not vested in the company, so that the liquidator cannot claim to be the representative of the creditors for the purposes of recovering debts due to them and his role is restricted to claiming contribution on behalf of the company.
[46] Section 178(1) Companies Act 2006.
[47] *Cullerne v London and Suburban General Permanent Building* Society (1890) 25 QBD 485.
[48] *Industrial Development Consultants v Cooley* [1972] 2 All ER 162.
[49] Section 178(2) Companies Act 2006.

company, it is only the company who can commence an action for a breach of duty against its directors. In certain limited circumstances, the shareholders of the company may commence a derivative action or claim against the company's behalf.

A director may be found personally liable for the company's debts under section 212 of the Insolvency Act 1986 for misfeasance and breach of duty. Directors of companies who commit wrongful trading under section 214 of the same Act also face a double sanction because running in parallel with the liquidator's power to bring wrongful trading claims is the power of the Secretary of State (through the medium of the Insolvency Service) to commence proceedings under the Company Directors Disqualification Act (CDDA) 1986 on various grounds including trading on the credit of suppliers and creditors. However, these proceedings require the proof of more cogent evidence to satisfy, given the severity of the allegation.[50] However, the provisions are in other ways very similar to a wrongful trading claim, except that the claim is not brought by the liquidator and the sanction is not personal liability for the company's debts, but disqualification from acting as a company director for a period of between two and 15 years.

Relief from liability

Full or partial relief from liability for negligence, default, breach of duty or breach of trust can be obtained if it can be established that the director in question was honestly, reasonably and ought fairly to be excused.[51] The defence requires all three conditions to be satisfied.[52] The breadth of this test is such that it might be argued that a director falling within the ambit of the test would be in breach of his duties in the first place. Such was the case of *Re Ortega Associates Ltd*,[53] where the courts,

[50] See *Re Living Images Ltd* [1996] 1 BCLC 348.
[51] Section 1157 Companies Act 2006.
[52] See *Re Oxford Pharmaceuticals Ltd* [2009] 2 BCLC 485.
[53] [2008] BCC 256.

having concluded that there has not been a breach of duty, stated that if there had been a breach, relief would have been available to the director.

The issue of relief has also arisen in respect of wrongful trading under section 214 of the Insolvency Act 1986. By way of defence to a claim of wrongful trading, section 214(3) provides that the court will not hold a director liable, if once he found himself in a position where he knew or ought to have known that the company was going into insolvent liquidation, he took every step with the view to minimising the potential loss to the company's creditors. The facts which a director ought to know or ascertain for the purposes of section 214(3) are determined predominantly by way of objective assessment as section 214(4) refers to a reasonably diligent person. In *Re Produce Marketing Consortium Ltd (No 2)*,[54] Knox J examined the link between sections 1157 and 214. He took the view that section 214 contains sufficient safeguards for the protection of directors and that the provision could not be easily accommodated with the 'essentially subjective approach that section 1157... requires.'[55] Construing section 214(4), he was of the opinion that its objective and subjective elements required each director to be judged on the facts actually known to them but also according to those facts which should have been known had the accounts been duly delivered, which is incidentally, parallel to the standard which has been imposed in relation to directors' care and skill generally by section 174 of the Companies Act 2006.

It is therefore extremely important that directors of companies on the verge of insolvency do all they can to comply with their fiduciary duties. They must consider any material piece of information relating to their corporate decisions and must also consider whether their decision maximises the value of the company. In order to achieve this, it is submitted that the board of Directors must meet often and carefully document what occurred during each meeting in the minutes. Directors must independently consider the impact of any actions that they have the authority

[54] [1989] 5 BCC 569.
[55] ibid 604.

to either implement or prevent. In *Re White and Osmond (Parkstone) Ltd*,[56] Buckley J formulated what has become to be known as the 'sunshine test':

> ...there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them gain and disperse the fog of their depression are not entitled to incur credit to help them get over the bad time.

In *Re Continental Assurance Co. of London plc.*,[57] Park J pointed out, at para 281, that:

> ...whenever a company is in financial trouble and the directors have a difficult decision to make, whether to close down and go into liquidation, or whether instead to trade on and hope to turn the corner, they can be in a real and unbelievable dilemma.

If they continue trading and there is no recovery, they are at risk of a claim for wrongful trading or as in *Secretary of State for Trade and Industry v Gill*,[58] disqualification. If they close down immediately, there will inevitably be an insolvent liquidation and they will be criticised for not having had the courage to carry on, with the probability of trading out of difficulty. In *Re Continental Assurance Co of London plc.*,[59] it was held that the decision of the directors to continue trading after large and unforeseen losses had caused a financial crisis which they were advised had not caused the company to be insolvent, was entirely appropriate.[60] In *Secretary of State for Trade and Industry v Gill*,[61] directors were not disqualified for making a commercial judgment to continue trading when 'they

[56] Unreported, 30 June 1960.
[57] [2001] BPIR 733.
[58] [2004] EWHC 933.
[59] (n 54).
[60] (n 54) [292].
[61] (n 55).

reasonably believed that there was a reasonable prospect of finding a corporate solution, thereby achieving a satisfactory outcome for all the group's creditors.'[62] Similarly, incurring a contingent liability, such as a warranty, knowing that it might be possible to meet that liability, is not necessarily fraudulent.[63]

In *Secretary of State for Trade and Industries v Taylor*,[64] Chadwick J said the following, in relation to an application to disqualify a director:

> The companies legislation does not impose on directors a statutory duty to ensure that the company does not trade while insolvent, nor does that legislation impose an obligation to ensure that the company does not trade at a loss...Directors may properly take the view that it is in the interest of the company and of its creditors that, although insolvent, the company should continue to trade out of its difficulties. They may properly take the view that it is in the interest of the company and its creditors that some loss-making trade should be accepted in anticipation of future profitability. They are not to be criticised if they give effect to such views, properly held. But the legislation imposes on directors the risk that trading while insolvent may lead to personal liability. Section 214 imposes liability where the director knows or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

Protecting Directors of Insolvent or Nearly Insolvent Companies

Under either insolvency test, courts may judge with hindsight whether the company was insolvent at the time that the corporate decision in question was made,

[62] (n 55) [157].
[63] *Norcross Ltd v AMDS* (1980) 131 NLJ 213.
[64] [1997] 1 WLR 407, 414.

notwithstanding contrary presentations made in the company's audited financial statements or made to its Board of Directors. It would be prudent for the director to adopt a conservative approach to its evaluation of the company's solvency and assume that the company is insolvent or within the zone of insolvency if there is any reasonable question about the corporate solvency. As a company approaches insolvency, its directors face potential liabilities from different sources and the decisions they make will be subject to a different set of rules. The following paragraphs contain strategies that directors may employ to minimise the risks they may face.

1. Strict compliance with fiduciary duties

Directors must monitor their company's financial position very closely to determine whether it is operating in the zone of insolvency. Directors must assess the fair value of the company's assets and liabilities conservatively and assume that the company is insolvent, if there is any reasonable question whether the company is insolvent under either insolvency test. When acting on the assumption that the company is in the zone of insolvency, directors should approach every decision with the object of enhancing the wealth of the company. They should also assume that they will not be able to take advantage of the business judgement rule and that they will have to defend the intrinsic or entire fairness of those decisions.

2. Establish a methodology for determining solvency

Because determining the solvency of a company is an inexact science at best and the courts may use hindsight in judging the solvency of a company at the time of a contested corporate action, it is advisable for directors to use as many data points as possible to help determine solvency. This can be done in many ways, for instance, the directors may review the company's historical financial statements, calculate the applicable financial ratios for the company and compare this with the ratios of the competitors. Directors can also review the company's business plan projections and

assumptions and compare them to historical performance, the expected performance of competitors and industry trends. Directors should investigate and analyse the company's business by assessing the current conditions and external competitive factors that will impact its operations and financial performance. Current market conditions that would impact on the company's sources of funding must also be considered. The sensitivity of the company's financial projections must be tested in respect of its revenue variations, margin variations and interest rate charges. Directors should also test the company's liquidity and free cash flow levels against the company's financial projections. Besides investigating and assessing the company's contingent and off-balance sheet liabilities, its asset must also be assessed from time to time.

3. Retain professionals to value assets

A director is, however, not entitled to rely on the advice or opinions of others blindly. The reliance must have been in good faith, having made an independent assessment of the information or advice and taking into account the director's knowledge of the corporation and the complexity of the structure and operations of the corporation. Should a particular director be a specialist in a particular field, one may assume that the other directors, taking into account their knowledge, or more particularly, lack thereof relating to this matter, are entitled to rely on the opinion of the expert director. Professional advice is often necessary to assist directors in identifying whether the company is in the zone of insolvency.[65] Generally, the advice of qualified counsel and financial advisors should be sought whenever directors are considering a transaction or other actions of significance to the company, its shareholders, and its creditors. In many circumstances, directors will

[65] In *Dovey v Cory* [1901] AC 477, it was held that a director can neither be expected to watch the subordinate officers of the corporation, nor to verify the calculation of the auditor himself, as the business of life cannot go on if the directors cannot trust those who are put in a position of trust for the express purpose of attending to the details of management.

not be able to satisfy the duty of care without the advice of legal and financial professionals.

4. **Avoid conflict of interest**

This duty requires that directors put the interests of the company and its shareholders and creditors, if the company is in the zone of insolvency, above the personal interests of a director or controlling shareholder. Directors, in complying with an extended duty to include creditors' interests, must avoid self-dealing and insider preferences where the directors themselves are shareholders in the company. The duty of directors to avoid a conflict of interests entails that directors should not exploit assets or opportunities of the company for their own benefit.[66] This principle has a twofold practical effect. The first is that directors are in general not entitled to any benefit deriving from them holding the office of director in a company, beyond what the company is willing to pay them. The second is that they cannot, in general, conclude valid contracts with the company. To avoid liability for breach, directors are required to declare the nature and extent of the interest to the other directors.[67]

5. **Avoid preferential treatment of insiders**

In order to comply with section 172 of the Companies Act 2006, directors are now required not only to act in the interest of the company and its shareholders but also other stakeholders. In doing so, directors must avoid preferential treatment of other directors who also are shareholders in the company, favoured shareholders or any other discrete creditors or stakeholders.

[66] Section 175 Companies Act 2006.
[67] Section 182 Companies Act 2006.

6. **Fully disclose the material aspects of a transaction**

Directors must ensure that material aspects of a transaction, for example, as self-dealing directors[68] or otherwise, is disclosed to an independent board of directors before decisions are made. This includes all relationships with principals in any transaction, interested third parties and any suggestion that the transaction itself may benefit the director concerned.

7. **Base all corporate decisions on accurate information and sufficient deliberation**

Directors have the duty to act with care, skill and diligence in accordance with section 174 of the Companies Act 2006. In doing so, they must avail themselves of all material information before making any decisions. This includes reports, studies and any other documents prepared by professionals or employees of the company or even professional bodies and authorities.

8. **Maintain corporate records documenting compliance with fiduciary duties and corporate formalities**

As the courts may look at decisions made by directors with perfect hindsight, it would be useful and prudent for directors to maintain detailed and accurate corporate records documenting compliance with their fiduciary duties and adherence to corporate formalities. Minutes of board meetings for instance need to contain detailed description of each significant item discussed by the directors including a summary of the topic, the material issues presented in considering the topic, and the major factors taken into account or relied upon in reaching a decision.

[68] Section 177 Companies Act 2006.

9. Take advantage of safe harbour provisions

To the extent possible, directors should ensure that all steps are taken to comply with and maximize the benefits of defences which provide relief against liability, also known as safe harbour rules, such as sections 214(3) of the Insolvency Act 1986 and 1157 of the Companies Act 2006. Directors should also ensure that decisions are made only after appropriate deliberation and consideration of all material information reasonably available to them. By taking these steps, directors can help ensure compliance with their duty of care and thus preserve the protection of the defences available under the various legislation.

10. Take steps to minimise liability arising from corporate transactions

In order to avoid or minimise liability for transactions taken by the company when it is insolvent or in the zone of insolvency, directors should comply with their duty of care and thoroughly examine the benefits and risks of each transaction. If a transaction results in the insolvency of the company or leaves it with unreasonably small capital, courts may assume that the transaction was improper and deny directors the benefit of the business judgment rule.

a. Comply with laws regarding the payment of dividend

Directors should ensure that the Board complies with all applicable laws regarding the payment of dividends, in accordance with the company's articles of association.

b. Be very cautious when engaging in insider transactions

Directors must carefully monitor transactions involving the company in which they or another director has either a direct or indirect interest.[69] Because of the danger that the director who is an insider, by virtue of his shareholding in the company, can benefit at the company's expense, these transactions are subject to heightened

[69] ibid.

scrutiny. The Companies Act 2006 in section 175 and 177 is very clear that the directors are prohibited from acting in conflict of interest or acting as self-dealing directors. However, where directors commit a breach of section 175 for conflict of interest, section 175(4) relaxes the duty if the situation cannot reasonably be regarded as amounting to a conflict of interest or the matter has been authorised by the Board.[70] Self-dealing[71] occurs where directors are said to have an interest in a transaction to which the company was a party. Megarry VC observed in *Tito v Waddle (No 2)*:[72]

> The self-dealing rule is...that if a trustee sells the trust property to himself, the sale is voidable by any beneficiary *ex debito justitiae*, however fair the transaction...Equity is astute to prevent a trustee from abusing his position or profiting from his trust: the shepherd cannot become a wolf.

To avoid liability (civil and criminal liability which arise respectively for breach of sections 177 and 182), article 85 of the 1985 Table A and section 317 Companies Act 1985 permit directors to have interests in conflict transaction, provided they were declared to the Board.

c. Beware of fraudulent transfer and preference liability

The Insolvency Act 1986[73] prohibits a transaction entered into for the purpose of putting the assets of a company beyond the reach of a creditor, current or prospective, or of otherwise prejudicing the interest of the claimant. The transaction is vulnerable to being unwound at any time, whether or not the company is insolvent. It also prohibits preference being given to a creditor or guarantor or

[70] Section 175(6) Companies Act 2006 provides that Board authorisation is effective only if the conflicted directors do not participate in the vote taking. In any case, the votes of the conflicted directors in favour of the decision must be ignored and they are not counted in the quorum.

[71] (n 67-68).

[72] [1977] Ch 106.

[73] See section 423 Insolvency Act 1986.

surety of its debts if the company does anything or allows anything to be done which has the effect of putting that person in a position which, if the company was to go into insolvent liquidation, would be better than the position he would have been in if the thing had not been done.[74]

11. Continue to comply with applicable statutes and regulations

As a company encounters financial problems, directors may consider improving its short-term liquidity position by temporarily ceasing to comply with certain laws or government regulations. This may include delaying the payment of trust fund taxes or failing to take steps necessary to comply with labour, environmental, or other regulations. However, directors may face personal liability for a company's failure to comply with these laws and regulations. The prudent course for the long-term interests of both the company and its directors is to continue to comply with these laws and regulations.

12. Consider taking out a D&O (Director and Officer) insurance policy

D&O cover protects a director or officer against those potentially significant personal liabilities that may arise from their negligence and breach of duty when acting in their capacity as a director or officer. It is also important to attract high-calibre personnel who may otherwise be wary of taking such positions, particularly for large multinational companies exposed to multijurisdictional regulation and legal systems. However, D&O insurance also protects the company's balance sheet in various ways. While D&O insurance generally covers the liabilities of directors to third parties, subject to the terms of the cover agreed, there is no legal basis why it cannot also cover directors' and officers' liabilities to the company itself. This is an important issue in today's economic climate where directors may be binding their companies to liabilities where they are either acting vicariously or outside of

[74] ibid section 238.

their authority. In the UK, exposures have recently increased for directors following the enactment or implementation of legislation such as the 2006 Act, the Environmental Liability Directive (ELD) 2009, the Corporate Manslaughter and Corporate Homicide Act 2007, the Extradition Act 2003, and, more recently, the Bribery Act 2010. A company may also indirectly benefit from D&O cover. This occurs where the company itself has suffered losses as a result of the directors acting beyond the scope of their authority or where it is vicariously liable to third parties by reason of the actions of its directors. Ordinarily the D&O insurance would not provide cover for fines and penalties. However, where the penalty or fine is not levied against the defendants directly, the cover is likely to apply. Insurance is an important tool for risk managers to transfer risks from the companies' balance sheets to insurers. D&O insurance adds an important dimension as it helps to attract high-calibre directors to roles in a corporate world that is the target of increased regulation. For the company, D&O insurance also provides routes for reimbursement for their indemnification of directors, but also indemnity in respect of the directors' and officers' wrongful actions causing losses to the company itself.

Conclusion

Given the kind of liabilities directors may face when the company is insolvent or in the zone of insolvency, it is critical that directors still have regard to corporate governance principles and their duties in times of financial difficulty. In order to satisfy their legal obligations, directors should keep the company's position under constant review when in the zone of insolvency, in most cases on a day-to-day basis, to ensure that there remains a reasonable prospect of the company avoiding an insolvent liquidation and that action taken in relation to the company is not contrary to the best interests of the creditors.