Directors' Duties and Related Matters

England and Wales – 2024

Scope and Purpose of This Note

This note summarises the duties that directors of companies incorporated in England and Wales are subject to.

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Directors' Duties

- Directors have statutory duties that they owe to the company. Each director owes these duties individually. In the exercise of those duties, generally and while the company trades solvently, the directors must act in the way they consider in good faith would be most likely to promote the success of the company for the benefit of its members as a whole. Their statutory duties require that directors also take into account wider factors, such as the environment, employees, the standard of their business conduct, business relationships with suppliers and customers, and any other relevant circumstances.
- If the company becomes insolvent, while these statutory duties are still owed legally to the company, they become subject to other interests to which the directors should have regard, such as those of the creditors of the company. However, the interests of the shareholders are still relevant.
- The directors need to be aware that where the company is in or is approaching the "zone of insolvency" (e.g. where the company may be at risk of insolvency if an anticipated refinance or sale does not complete), then the duty to promote the success of the company for the benefit of its shareholders is modified, and requires the board to have regard to the interests of the company's creditors. Balancing the interests of shareholders and creditors during this period and whether it is the creditors or shareholders who would be prejudiced by a decision is extremely challenging. It is therefore vital that the board seek professional advice to assist them during this period.
- A breach of any of the statutory duties is actionable by the company, and any right of action could be exercised by an appointed insolvency practitioner should the company later enter a formal insolvency process.
- The law makes no distinction between executive and non-executive directors or shadow directors. All members of the board have the same duties to the company. A director must exercise reasonable care, skill and diligence. This means the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by a director in relation to the company and the general knowledge, skill and experience of that director.
- While the interests of shareholders remain relevant during any period in which the company is or may be insolvent, the directors should not be influenced by any power any individual shareholder has to remove or replace the directors (or any of them) and must act in what they consider to be in the best interests of the company's creditors as a whole.

Trading Insolvently/Wrongful Trading

- A company is likely to be insolvent if:
  - It cannot meet all its present and due payment obligations (i.e. it is unable to pay its debts when they fall due), in which case it is likely to be insolvent on a cash flow basis.
  - The value of its assets is less than the amount of its liabilities (taking into account its contingent and prospective liabilities), in which circumstances it is likely to be insolvent on a balance sheet basis.
- Directors should be aware that while there is no statutory prohibition against trading while insolvent, there could be some degree of risk of the directors being required to contribute personally to the assets of the company if they continue to do so.
- If the directors continue to trade in circumstances where they knew or ought to have concluded that the company was insolvent, or bordering on insolvency or that there was no reasonable prospect that the company would avoid going into insolvent liquidation or administration, then they may be liable for wrongful trading under section 214 of the Insolvency Act 1986 (IA 1986).
- In such circumstances, the directors could be personally liable for any losses suffered by creditors caused by continued trading unless they take every step possible with a view to minimising those losses that they ought to take.
- The key consideration for directors is, therefore: "Is there a reasonable prospect of avoiding insolvent liquidation or administration?" If there is, the directors are more likely to be able to defeat a claim for "wrongful trading" so long as they hold that belief reasonably, having regard to information available to them and the standards of skill and care expected of them. However being able to evidence that believe is critical and taking professional advice and proper record keeping (see below) is essential.

Misfeasance Trading – the BHS Case

- In addition to wrongful trading, in the "BHS case" (*Wright v Chappell*) the court introduced the concept of misfeasance trading, which also carries a risk of personal liability and is more easily established than wrongful trading.
- Directors can be liable for misfeasance trading if they continue to trade a company in breach of their directors' duties, when if they had complied with those duties, the company would have gone into administration or insolvent liquidation earlier.
- This claim is easier to establish than a claim for wrongful trading, because it is not necessary to show that insolvency was inevitable, and it can also arise at a much earlier point than a claim for wrongful trading.
- In the BHS case, the court found the former directors of BHS liable for misfeasance trading some six months before they became liable for wrongful trading. At that time, the company was not cash flow insolvent, neither was liquidation or administration inevitable.
- Directors therefore need to be cognisant that the risk of personal liability may arise much earlier than it would for a claim for wrongful trading.
- The level of compensation the directors had to pay personally in the BHS case was £110 million, and the court was not prepared to limit liability based on the level of D&O cover the directors had, or their personal financial circumstances.
- This type of claim is most likely to arise as a consequence of a director breaching their duty to promote the success of the company, which, when a company is trading in the "zone of insolvency" is modified and requires directors to consider the interests of creditors, as well as the interests of the company.
- The BHS case highlights the importance of taking advice, considering and applying it and the importance of record keeping – had the directors been able to justify their decision making they may have been able to defeat this claim.

Mitigating the Risk of Personal Liability

General Considerations

- Directors should, among other things, consider whether:
  - The company is presently operating within existing facilities while managing the position with creditors generally
  - The company's financiers have withdrawn any facilities previously made available to it (such as overdraft facilities) or have indicated that they will be unable to provide ongoing support
  - The impact on the company's cash flow will be material if the company has deferred payment
  - The company is able to apply for a "time to pay" (TTP) arrangement with HMRC to spread its current tax liabilities
  - Its shareholders have been made aware of any additional working capital requirements and have indicated a willingness to extend facilities to the company
  - There is a realistic prospect that the company can be sold as a going concern at a value sufficient to ensure all creditors will be paid in full, with a return to shareholders, and have instructed advisors to market the business
- The directors should be aware that there may be a risk of challenge to their view if any assumptions that they were making relating to these points prove to be materially inaccurate. If the company subsequently enters into an insolvency process, then the period of trading prior to that formal insolvency process will be reviewed by an insolvency practitioner with the benefit of hindsight. To mitigate against this risk, the following matters should be carefully and regularly reviewed during this period of uncertainty to ensure that so far as possible:
  - Any new credit, supplies and services are necessary and *bona fide* for the purpose of continuing the business
  - Any transactions out of the ordinary course of trade are the subject of particular scrutiny and avoided wherever possible.
  - The company is able to meet payroll for employees.
  - No creditors are specifically preferred (see below) or transactions entered into at an undervalue (see below) unless in good faith and that are critical to ensure the survival of the business and the prospects of achieving a turnaround and/or solvent disposal/restructuring.
  - The directors work to develop expeditiously a credible business plan for the immediate term with as realistic and prudent assumptions as it is possible to make, incorporating reasonably achievable options for a recovery for creditors and (if possible) a return to shareholders.
  - The directors consider what contingency strategies could be put in place to protect the interests of creditors should the new business plan prove unsuccessful (see below).
  - The directors consider the net deficiency position of the company's assets immediately and analyse whether it is believed continued trading will either reduce or increase that deficiency. The directors should keep this under regular review with a comparative analysis of the net deficiency compared against what would be the position if continued trading had not occurred and regularly forecasted for a week in advance. This will provide supporting evidence that losses to the company were constantly under review and corrective action to reduce losses was taken at an early stage. The analysis must show that any continued trading is intended to reduce the net deficiency of the company, but also that it is designed appropriately so as to minimise the risk of loss to individual creditors. This exercise should be further reinforced by circulating the net deficiency analysis to an insolvency practitioner each week for advice in respect of continued trading.

Record Keeping

- The board should keep full and accurate minutes of its reviews, decisions (including any dissenting views of individual directors), the reasons for those decisions and the information (particularly financial information) upon which such decisions are based.
- The board should consider holding board meetings regularly (e.g. once a week or even daily) if the company is in distress.
- The minutes should also reflect specific discussions and considerations and refer to any professional advice that has been received. The board's legal advisers can assist in preparing those.

Professional Advice

- It is critical that the board takes, and acts upon, professional advice, as this goes a long way towards a director being able to show that they are making informed decisions and are appropriately discharging their duties, in particular their duty to take reasonable care.
- However in order to rely upon professional advice to minimise the risk of a claim, the directors must provide full and accurate information to their professional advisors

Personal Liability – Other Risk Areas

Liability for Tax Debts

- Directors should be aware that the Finance Act 2020 introduced legislation with the aim of deterring individuals from placing a company into insolvency as a means to evade a company's unpaid tax liabilities. The legislation allows HMRC to issue a notice making directors (including former directors) and shadow directors jointly and severally liable for unpaid tax owed to HMRC by the company.
- The circumstances in which HMRC can issue such a notice are complex but are designed to combat tax avoidance, tax evasion and cases of repeated insolvency and those where the company has been charged a penalty for facilitating tax avoidance or evasion.

Personal Guarantees

- Directors should be aware that any who have given personal guarantees may be personally liable for the company's debts under them.

Dividend Payments

- A dividend may be unlawful to the extent that the dividend is in excess of available distributable profits.
- A dividend may be challengeable as a transaction at an undervalue even if the company has distributable profits if the company subsequently enters insolvency.
- A director who authorises payment of an unlawful dividend may be personally liable to repay or restore funds in respect of losses caused to the company, even if the director is not a shareholder, if they have acted in breach of their duties.

Possible Redundancies

- The directors should consider, at an early stage, whether redundancies to the company's workforce may be necessary in order to save the business, and if so, whether consultation is required pursuant to the Trade Union and Labour Relations (Consolidation) Act 1992 (TULRCA).
- Under section 188 of TULRCA, there is an obligation on the company to inform and consult appropriate representatives of affected employees when 20 or more redundancies are proposed to take effect in a period of 90 days or less. The appropriate representatives of affected employees are either trade union representatives or, where no trade union is recognised, employee representatives elected for the purposes of consultation. The directors should consider what steps will need to be taken to effect collective consultation. Consultation must last for a minimum of 30 days where 20-99 redundancies are proposed (or at least 45 days if 100 or more redundancies are proposed) prior to any dismissals taking effect.
- For completeness, where an employer proposes to dismiss fewer than 20 employees within a 90-day period, there is no requirement to consult collectively with representatives of affected employees. However, an employer is still required to follow a fair procedure if it wishes to avoid unfair dismissals.
- Under section 193 of TULRCA, there is an obligation on the company to notify the Secretary of State (currently via the Department for Business, Enterprise and Industrial Strategy (BEIS)) in writing using Form HR1 in a collective redundancy situation. Again, notification is to be received by BEIS at least 45 days before the first dismissal takes effect where the company is proposing to dismiss 100 or more employees, reduced to at least 30 days for between 20 and 99 employees.
- The directors should keep full and accurate minutes of the board's proposals, and in respect of decisions taken to make any employees redundant, ensure that consideration has been given to the company's obligations to consult collectively and to notify the Secretary of State. In the case of the collapse of parcel delivery firm City Link Limited, a prosecution was initially brought against the directors for not notifying the Secretary of State. While the City Link directors were eventually acquitted on the narrow facts of that case, there is a real risk that directors who are proposing to make redundancies could be prosecuted for failing to notify in the event of any delay in doing so. The directors may even wish to notify the Secretary of State as a protective measure. While it remains to be seen how strictly this requirement will be enforced in the current circumstances, directors should continue to comply with the notification provisions to avoid risk of prosecution.

Contingency Strategy

Having identified a solvency risk in the business directors should immediately consider what steps they should be taking in order to protect the business. Presently businesses are operating in a challenging global economic environment which has seen inflationary price hikes, increased borrowing costs, energy costs spike and supply chain challenges. A number of businesses face challenges posed by these external factors and will be at risk of trading while insolvent and in these circumstances the directors will need to take every step to minimise losses to creditors. This does not necessarily mean an immediate cessation of trading, but businesses may need to restructure to remain viable and we would recommend taking urgent further advice on the options available.

Challengeable Transactions

- **General**

  Certain transactions that take place at a time when a company is insolvent, or becomes insolvent as a result of the transaction, are open to challenge by an appointed insolvency practitioner if the company subsequently enters a formal insolvency procedure.

  Directors, to the extent responsible for such transactions, can be held personally liable for any loss suffered by the company as a result of the transaction, both under IA 1986 and as potential misfeasance. See also the BHS Case as discussed above in the section "Misfeasance Trading."

  Directors should be aware of the grounds for such challenges and, in considering any relevant transactions, determine whether it is appropriate for such transactions to proceed. Any such decisions should be carefully minuted.

- **Transactions at an Undervalue (s 238 IA 1986)**

  A transaction will be at an undervalue if it is a gift by the company, or the company receives no consideration, or the value of the consideration received by the company (in money or money's worth) is significantly less than the value of the consideration given by the company in the transaction.

  If assets are disposed of directors should keep records of the basis on which the disposed asset was valued and why.

  Any such transactions taking place within two years of formal insolvency will be open to challenge, if they took place at a time the company was insolvent or became insolvent as a result of the transaction (which is presumed if the transaction was with a connected party).

  However, the transaction will not be subject to challenge if:

  – It was done in good faith for the purpose of carrying on the business

  – The directors had reasonable grounds for believing that it would benefit the company

  Therefore, in considering any asset disposal to raise liquidity (for example) at less than market value, the directors should address specifically whether it is justifiable on the grounds set out above. We recommend specific advice is taken in relation to any relevant transaction, and the decision is carefully minuted at the time.

- **Preferences (s 239 IA 1986)**

  A preference is a transaction with a creditor (or a surety or guarantor of any of the company's liabilities) under which the creditor is placed in a better position than it would have been in if the transaction had not occurred and the company proceeds into insolvent liquidation.

  A preference is open to challenge if the company proceeds into formal insolvency within six months of the transaction in question if the creditor is not a connected party, and within two years if the creditor is connected. This is provided the company was insolvent at the time, or became insolvent as a result of the transaction (which is presumed if the creditor is connected).

  However, in effecting the preference, the directors must have been influenced by a desire to give the creditor the preferential position. This is presumed for transactions with connected creditors, but can be rebutted.

  In circumstances where decisions have to be made on a daily basis during cash flow difficulties as to which creditors to pay, preference issues are highly relevant. In this regard, the directors should consider the following:

  – Is the payment necessary for the continued operation of the business and, therefore, necessary to preserve the prospects of a going concern survival and payment in full to creditors, i.e. is it business critical? This may include payment to key suppliers of goods and/or services where such supplies are critical and cannot easily be resourced elsewhere at the speed and price required. Consideration should be given as to whether payment over time for historical debt can be agreed as a condition of continued supply.

  – Is the payment necessary to avert action being taken by the creditor, which may prejudice the survival of the business? If payment is made under threat of winding up proceedings, or legal proceedings that the company cannot defend or afford to defend, or to avoid distraint on goods, it is unlikely to be considered a preference. Evidence of this threat and the company's response should be documented.

- **Directors' Remuneration, Expenses and Employees**

  – As connected creditors of the company, particularly attention should be paid to discharging outstanding expenses claims and arrears of remuneration to directors. It would be questionable if, significant arrears of expenses and remuneration are discharged when other creditors are not being paid.

  – Employees, on the other hand, will be a necessary part of continuing to operate the business. As directors under a contract of employment are employees and a critical requirement to ensure the company is managed through this phase, ongoing payments of remuneration and expenses (and general payroll) may be appropriate to ensure continued services to the company. Payment of arrears of remuneration and expenses claims may be justifiable in the circumstances, if not to do so would cause genuine financial hardship for the director personally, such that the director could not continue with their responsibilities without seeking an alternative source of income. If such circumstances exist, any such director should consider taking independent advice on their personal position if the directors as a whole consider such payment cannot be made presently within the resources available.

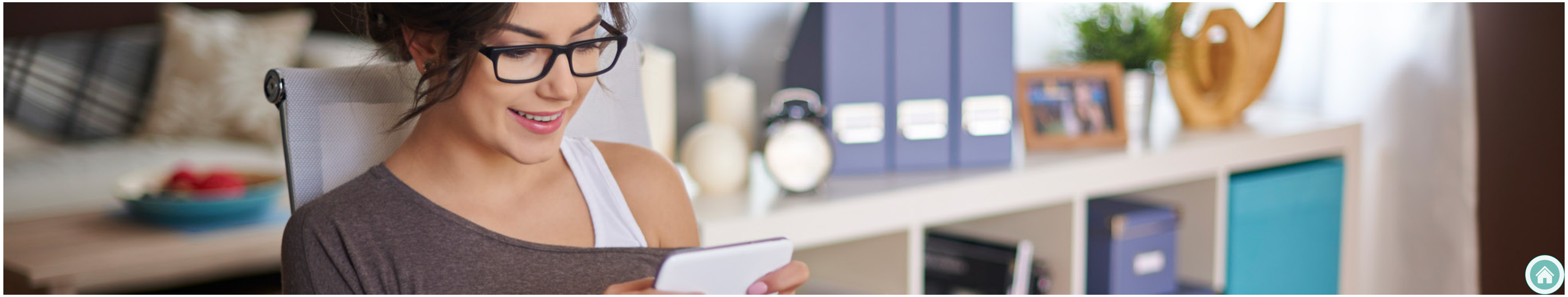
- **Unpaid National Insurance Contributions (NIC)**
  - If a company does not pay the correct amount of NIC, HMRC has the power under s121C of the Social Security Administration Act 1992 to issue Personal Liability Notices to recover the unpaid NIC plus interest and penalties from the directors or any other officers personally. Before issuing a notice, HMRC must be satisfied on the balance of probabilities that the failure to pay was due to fraud or neglect, judged by an objective test.
  - HMRC will consider issuing a notice where, in the face of persistent failure to pay NIC, a company made significant and/or regular payments to other creditors, connected persons or companies, or in the form of directors' salaries.

Directors Disqualification

- Where a company proceeds into formal insolvency, the appointed insolvency practitioner has a duty to report to the Secretary of State on the conduct of each of the directors and former directors of the company. The Secretary of State must then decide whether to bring proceedings against the directors to disqualify any of them from acting as a director or in the promotion, formation or management of any company on the grounds of unfitness, for between two to 15 years.
- The directors should, therefore, be aware that should it not prove possible ultimately to effect a solvent turnaround and/or disposal, their conduct as directors (particularly at this time and going forward) will be subject to scrutiny.
- It is, therefore, critically important for this reason, and to deal with risks in relation to all the matters raised in this note, that the directors regularly (i.e. at least weekly) review the ongoing financial position and progress of the business plan, any relevant transactions for which particular consideration should be given, and its continuing belief in the appropriateness of continuing trading.
- All such reviews should be carefully minuted, to include the information available to the directors, matters discussed, all views expressed and considered, any decisions reached and the rationale for such decisions having regard to the points and recommendations made in this note. The directors should also keep a notebook of daily discussions and matters, so that there is always a contemporaneous note to support their actions in the conduct of the business during this time.

Deposits and Trust Accounts

- There is no case law or statutory authority that states, in the company's present circumstances, the directors are under a duty to protect deposit creditors by the operation of a trust account to "ring-fence" deposit monies.
- By contrast, there is case law authority that highlights the risk of a preference in creating a trust for such creditors and using company funds to place monies into a trust account for this purpose. Further, within the context of director disqualification, the courts have held that where directors are pursuing a reasonable prospect of avoiding an insolvent liquidation and a full return to all creditors, there is no legal obligation to depart from normal trading practice so as specifically to protect deposits and pre-payments by a trust account.
- Where there is uncertainty regarding the current position, we do not believe the directors could be criticised for seeking to protect deposits received going forward by the operation of a properly constituted trust account, but would make the following comments:
  - At the time of receipt of the deposit, it must be paid on an express trust obligation (or on terms that evidence a trust) such that the deposit is properly held on trust. This would require clear terms and conditions with such customers to this effect (which we would be happy to assist with) and making sure operational practices are in place to ensure those terms apply. Even if deposits have been received, and placed in a separate account, there would remain a preference risk if the account is not properly constituted as a trust account to avoid the fund being regarded as an asset of the company.
  - Placing deposits on trust would reduce the working capital available to the company with which to pursue a recovery strategy that protects all creditors and a return for shareholders, thereby shortening the time available to achieve this.
  - If, in light of these comments, the directors elect not to proceed with arrangements for placing deposits on trust, we would nevertheless recommend that an account be set up or kept open (as applicable) for that purpose should it prove necessary in due course. In the meantime, the directors should take care not to actively encourage higher levels of deposits than would ordinarily be experienced to avoid any criticism in that regard.
- Should the company be at risk of trading while insolvent, we believe the courts are likely to consider placing deposits on trust as a step that "ought to be taken" to minimise losses to creditors.



Defined Benefit Pension Schemes

The UK Pensions Regulator (TPR) has far reaching powers, which are particularly evident when there is a restructuring of a sponsoring employer of a defined benefit (for example, final salary) pension scheme. In certain circumstances, directors could also incur liability. We have summarised below the key powers that could potentially impact a corporate recovery process. Directors should take appropriate professional advice before looking to restructure an employer with a defined benefit pension scheme.

- **Anti-avoidance Powers**

  Certain acts or omissions can result in TPR exercising its power to require a person that is connected or associated with an employer of a defined benefit pension scheme to make a payment into the pension scheme, where TPR considers that it is reasonable to do so. This power could capture other group companies and also directors in a personal capacity and is a measure that should be taken into account when restructuring a business. Failure to comply with a contribution notice could incur a criminal penalty of an unlimited fine, or a financial penalty of up to £1 million. Where a scheme employer is under resourced, TPR also has the power, in certain circumstances, to require another group company to provide support to the pension scheme, for example by way of guarantee or security.

- **Sanctions for "avoidance of an employer debt" or "conduct risking accrued scheme benefits"**

  Controversially, anybody involved with the running of a defined benefit pension scheme or the operation of an employer (e.g. company director) could be caught by two new offences of "avoidance of an employer debt" and "conduct risking accrued scheme benefits" if they do not have a reasonable excuse for their actions. These offences were introduced by the Pension Schemes Act 2021 and are not limited to those who are connected or associated with a scheme employer, in the way that a contribution notice is.

  The offence of conduct risking accrued scheme benefits includes any act or failure to act that detrimentally affects in a material way the likelihood of accrued scheme benefits being received where the person knew or ought to have known that such a course of action would be likely to have that effect. While the offence of avoidance of an employer debt could be said to be fault based, the offence of conduct risking accrued scheme benefits is not fault based. There does not have to be any intention to risk accrued pension scheme benefits in order for a person to be caught by this offence. The penalty for being found guilty of either of these offences is up to seven years in prison or an unlimited fine. Alternatively, TPR could issue a financial penalty of up to £1 million.

- **Notifiable Events**

  Certain transactions constitute "notifiable events" that must be notified to TPR after the event occurs. From April 2022, there will be new "super" notifiable events, in respect of which separate requirements will apply, such as a requirement to notify TPR and the trustees of a defined benefit pension scheme at certain points before completion of a transaction. There will also be a requirement to state the likely impact of the transaction on the pension scheme and whether compensation has been offered to the pension scheme trustees to take account of that likely impact. Failure to comply could incur a financial penalty of up to £1 million.

- **Financial Penalties Regime**

  The Pension Schemes Act 2021 introduced a financial penalties regime for certain acts/failures to act, including failure to make a notifiable event submission, and/or providing TPR or pension scheme trustees with false or misleading information. Directors as well as corporates can be caught by these sanctions, which could result in a fine of up to £1 million.

Restrictions on the Use of Company Names: (s 216 IA 1986)

- In the event that the directors wish to consider a management buyout from insolvency practitioners, they should be aware that it is an offence for a director or shadow director of a liquidated company to be involved either directly or indirectly with a new company with a similar name for a period of five years beginning with the day on which the old company went into liquidation. If a director breaches this provision, the penalties include imprisonment, a fine or both, together with personal liability for the debts of the new company.
- However, there are specific circumstances in which the above section will not apply and we can advise you further if required.

Contacts

John Alderton
Partner, Leeds
M +44 788 505 8896
E john.alderton@squirepb.com

Russ Hill
Partner, Birmingham
M +44 792 160 0409
E russ.hill@squirepb.com

Monika Lorenzo-Perez
Partner, London
M +44 778 572 0439
E monika.lorenzo-perez@squirepb.com

Charlotte Moller
Partner, London
M +44 788 180 4970
E charlotte.moller@squirepb.com

Devinder Singh
Partner, Birmingham
M +44 772 139 9625
E devinder.singh@squirepb.com

Jon Chesman
Director, Leeds
T +44 7545 110783
E jon.chesman@squirepb.com

Helena Clarke
Director, London
T +44 7827 238537
E helena.clarke@squirepb.com

Vanessa Stuart
Director, Manchester
M +44 7825 942711
E vanessa.stuart@squirepb.com

Ollie Ward-Jones
Director, Manchester
T +44 7720 064999
E oliver.ward-jones@squirepb.com

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