Liquidation Toolkit

Directors' Duties

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Kingston Smith & Partners
Licensed Insolvency Practitioners

Directors' Duties

Day-to-day management of a company is delegated to its directors by the shareholders. Directors are often confronted by difficult decisions that can have a dramatic effect on the business and its financial position. In certain circumstances, this can result in directors incurring personal liability for corporate debts should the company be subject to an insolvency procedure.

> "The director's role and powers are primarily defined in the company's articles"

Decision-making powers

The decisions of the directors are taken collectively by the board of directors. A director cannot act as a director on their own, unless only one director has been appointed. Decisions are either taken by majority vote at board meetings, or with the signing by all directors of a written resolution. The director's role and powers are primarily defined in the company's articles and, if they are also an employee, their service contract.

The mere fact of appointment does not normally give a director any executive powers. Most directors are, however, also employees of the company with specific powers delegated to them. A managing director usually has extensive powers to take day-to-day decisions on behalf of the company. Other directors, such as sales directors or finance directors, will have a more distinct role.

Directors owe a duty to the company and, if insolvency threatens, to creditors. Certain key duties of directors have been placed on a statutory footing under the Companies Act 2006. These duties are owed to the company. Directors are also subject to a number of other statutory requirements and restrictions. These include a duty to keep proper books and records, and restrictions on entering into certain transactions with the company, or accepting loans from the company. Breach of these duties and requirements can result in a director being disqualified from acting as a director and, in many cases, can lead to the director incurring personal liability.

Potential pitfalls

There are certain provisions of the Insolvency Act 1986 that directors need to be mindful of. Although they only apply when a company has gone into liquidation/administration, they relate to the conduct of the directors before the formal insolvency appointment.

Details of why the liquidator of an insolvent company may ask for an order from the courts for the director to be personally liable to contribute to the company's assets, and/or certain transactions to be set aside are set out further in this document. This applies equally to non-executive, shadow and de facto directors as well as to executive directors.

Section 212 - Summary remedy against delinquent directors by liquidators

The official receiver, a liquidator, a creditor or a shareholder can recover money or damages from officers of the company, or those concerned in its management, who have misapplied or retained, or become liable or accountable, for any money or property of the company, or have been guilty of misfeasance or breach of fiduciary or other duties in relation to the company.

This section covers, among other things, improper payments of dividends, application of monies for an improper or unauthorised purpose, application of monies contrary to the Companies Acts, and unauthorised loans or payments of unauthorised remuneration to its directors.

Section 213 - Fraudulent trading

A person knowingly party to the carrying on of any business of the company with the intent to defraud creditors (including potential creditors) of the company will be personally liable to contribute to the company's assets.

An intent to defraud may be inferred if a person obtains credit when they know that there is no prospect of funds being available to pay the debt. However, there must be evidence to justify a finding of actual dishonesty.

If this is proved then the director will, in addition to being liable to contribute to the company's assets, be guilty of a criminal offence.

It should be noted that this section applies in addition to the rules relating to common law misfeasance, but provides a speedier remedy than is available under common law.

Section 214 - Wrongful trading

The Liability will arise where a director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and then failed to take every possible step to minimise the potential loss to the company's creditors. In ascertaining the potential level of liability, consideration will be given to a person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as is carried out by the director (an objective test) and the general knowledge, skill and experience which the relevant director actually has (a subjective test).

The effect of this is that an experienced director in a large company, with sophisticated accounting procedures and equipment, will be required to conduct themselves to a

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higher standard than an inexperienced director in a small company with simpler accounting procedures.

However, even the inexperienced director in a small company must make sure that they have adequate knowledge and skill and that the company's accounting procedures and equipment can produce the information required to show the company's financial position.

The dilemma facing the director of a company at significant risk of going into an insolvency process is whether to carry on trading or put the company into some form of insolvency process.

The duty imposed is to minimise the loss to creditors and the steps to be taken will vary from case to case. All decisions taken by the directors, and the reasons for them, should be recorded in board minutes.

This section applies to any person who is, or was, a director of a company that subsequently goes into an insolvency process. It is not, therefore, possible to escape liability simply by resigning.

It is advisable to have a thorough evaluation of the situation professionally carried out to establish the best course to take.

Sections 238 - Transactions at an undervalue

A transaction at an undervalue occurs when a company disposes of its assets for significantly less than they are worth. A liquidator or administrator can apply to have the transaction set aside if it occurred within two years of the company's liquidation or administration.

Section 239 – Preferences

A preference is a transaction which places a creditor in a better position when a company goes into liquidation than if the transaction had not occurred. If the transaction occurs within six months of the company's liquidation, the liquidator can apply to have it set aside, but must prove that the directors were influenced by a desire to produce the preferential effect.

In the case of a transaction with a creditor who is a connected person (for example, any of the company's shareholders, subsidiaries or directors), the period of six months is extended to two years and it is also presumed (unless the contrary can be proved) that there was a desire to prefer the creditor.

Disqualification

A director faces disqualification:

- Two to five years. This shorter period of disqualification is usually sought for less serious offences;
- Six to ten years. This period is generally pursued for misconduct that is considered very negligent or serious, but not so serious as to merit longer;
- Ten to fifteen years. This period is pursued for the most serious cases of misconduct and usually reflect circumstances of fraud – most notable examples in recent years include carousel (or MTIC) fraud, land-banking and mis-selling.

In determining unfitness, the court considers (among other things) whether the director has been a party to the making of a preference, a transaction at an undervalue, or to wrongful or fraudulent trading, and whether they have failed to comply with the various duties relating to the keeping of books of account and the preparation of annual accounts, or has breached any fiduciary or other duty owed to the company.

Disqualification means that the director will not be able to be involved in the formation, promotion or management of any company in the United Kingdom during the disqualification period.

Directors are responsible for the day-to-day running of a company's business. They are governed, not only by statutory regulation, but also by common law fiduciary duties.

When a company is solvent, the directors have a common law duty to act in the interests of the company, its shareholders and creditors, coupled with a statutory duty to consider the interests of employees. Where the company is insolvent (or potentially insolvent), the directors' duty changes so that they are required to consider the interests of creditors and potential creditors first.

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Our team has decades of experience in advising directors of their responsibilities and fiduciary duties. We can assist them in managing their role and responsibilities and advise on the best course of action so as to mitigate as far as possible, the risk of personal liability.

It is important to note that many provisions apply, not only to formally appointed directors, but also to shadow directors and de facto directors.

Where the directors fail to have sufficient regard for the interests of the company's creditors in their management of the company, we can advise them of the risk of being disqualified under the provisions of the Company Director Disqualification Act 1986.

Timing is critical. The sooner a director takes professional advice, the greater the likelihood that the risk of personal liability and disqualification is diminished or removed.

Ian Robert

Partner

City: 020 7566 4020

Heathrow: 020 8848 5507

irobert@ks.co.uk

Brian Baker

Partner

City: 020 7566 4020

Redhill: 01737 781572

bbaker@ks.co.uk

Michaela Hall

Partner

St Albans: 01727 896015

mhall@ks.co.uk

Chris Purkiss

Partner

City: 020 7566 4020

Romford: 01708 759716

cpurkiss@ks.co.uk

Ryan Davies

Licensed Insolvency Practitioner

City: 020 7566 4020

rdavies@ks.co.uk

Dale Hernon

Head of Client Services

City: 020 7566 4020

dhernon@ks.co.uk

www.kspllp.co.uk

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DDLT0319