Compliance with directors' duties under threat of insolvency during the Covid-19 outbreak

A practical guide for directors of UK companies

30 March 2020

The purpose of this note

The profound business and market interruption already caused by the Covid-19 outbreak has introduced insolvency risks for many otherwise healthy businesses.

This note summarises the key concerns for boards facing those risks - either directly, or within their customer and supplier networks.

This is a general note, for information purposes. If you require more detailed advice on your specific circumstances, please contact a member of TLT's UK-wide Restructuring and Insolvency team, whose details are set out at the end of this note.

Company insolvency

When is a company insolvent?

In general terms, a company is insolvent if it is unable to pay its debts as and when they fall due.

A company may also be considered to be insolvent if the value of its assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities.

Covid-19 has introduced significant uncertainty to any assessment by directors about their company's solvency.

Why is it important to know when a company is (or might be) insolvent?

When a company is insolvent, or at serious risk of insolvency, its directors' primary duty shifts from protecting the interests of the company (and its shareholders), to prioritising the interests of the company's creditors as a whole.

Insolvent businesses face a heightened risk of terminal failure and creditor recovery action.

Insolvency also typically triggers defaults and termination rights under banking facilities and key commercial contracts. This may exacerbate risk, destroy value and undermine trading.

An insolvent business is particularly exposed to the risk of a winding up petition, which can result in bank accounts being frozen and curtails the ability to trade.

What should the board do if a company is (or might be) insolvent?

Plan. If a company's solvency is in doubt, its board should be assessing its prospects and devising and implementing turnaround and contingency plans to comply with their duty to creditors. Information will need to be updated and plans may need to be revised, as circumstances change.

Take advice. Professional advisers will need as much accurate and up to date information as possible, regarding the company's current and projected financial position. This will include accounts, valuations, cash-flow forecasts and creditor profiles.

Document. The importance to a board of documenting their decision making is never more important.

Directors' duties

What are a director's duties?

Each director must abide by seven statutory duties:

- To act within his or her powers;
- To promote the success of the company;
- To exercise independent judgment;
- To exercise reasonable care, skill and diligence;
- To avoid conflicts of interest;
- Not to accept benefits from third parties; and
- To declare an interest in proposed transactions or arrangements.

How do these duties change when a company is (or may be) insolvent?

When a company is **solvent** its directors owe their duties to the company, for the benefit of its shareholders as a whole.

When a company is **insolvent** or at serious risk of insolvency, its directors continue to owe existing duties but their overriding duty will be to act in the best interests of the creditors of the company.

Prior to the Covid-19 outbreak, when a company was insolvent and its directors knew (or ought reasonably to have concluded) that it would not avoid insolvent liquidation or administration, they were under a duty to take every step which a reasonably diligent person would take to minimise potential loss to the company's creditors. Failing that, they risked personal liability for any worsening of the company's financial position (known as '**wrongful trading'**).

However as part of its response to Covid-19, the Government announced on 28 March 2020 that the UK's wrongful trading provisions would be suspended temporarily, with effect from 1 March 2020, for an initial period of three months. Legislation to effect this change is anticipated imminently.

How can directors ensure that they are acting in accordance with their duties?

Shareholder ratification or sanction will not be sufficient to discharge directors' duties, if a company is insolvent and an action is not in the creditors' best interests. Directors must not act for any personal or collateral purpose.

Decisions to incur further credit should only be made if it is believed that this is in the best interests of the creditors as a whole and supports the turnaround plan. The fact that credit may be partially underwritten as part of the Government's response to Covid-19 does not change this position.

Creditors must not be misled about the company's financial position and the prospects of repayment when a company is incurring further credit.

Where possible, advice should be taken before actions are finalised and implemented.

Can a company continue to trade if it is (or may be) insolvent?

It is possible for a company to continue trading even if there is a threat of insolvency. In some cases this may be the most appropriate course of action and will be in the best interest of creditors as a whole.

Many businesses have been obliged to cease or suspend trading in response to Covid-19. Others are now taking urgent steps to limit trading activity so they can manage cash and reduce outgoings.

Despite the temporary suspension of the threat of wrongful trading, directors must still remain constantly alert to the risks in any case where their action or inaction may be increasing avoidable losses for creditors.

The UK Government's Insolvency Service retains the power to seek the disqualification of directors for a wide range of misdemeanours and to apply for compensation orders. Its press release announcing

the planned suspension of wrongful trading specifically referenced disqualification as "**an effective deterrent against director misconduct**".

Can a company still pay dividends to its shareholders if it may be insolvent?

A company must have profits available in order to make a distribution. Its directors should take expert advice before making any distributions to shareholders or anyone connected to shareholders while the company's solvency is in question.

Many companies are postponing dividend payments in response to the Covid-19 situation, even when those dividends have been properly declared and are due for payment.

The payment of a dividend may in some circumstances be open to challenge. The company does not need to be insolvent for such a challenge to be brought.

A director who authorises an unlawful distribution may be in breach of their duties and may be personally liable to repay the company.

Practical advice

Does the suspension of the wrongful trading laws mean that directors can allow companies to continue to trade during the Covid-19 outbreak without any risk of personal liability or criticism?

It's too early to tell but probably not. Although the HM Government press release which announced the suspension as allowing directors **"to keep their businesses going without the threat of personal liability",** wrongful trading is only one way in which directors may be held liable for some of the consequences of their company's insolvency.

Unquestionably, the suspension provides directors with some comfort that the authorities will be more sympathetic to certain financial decisions taken by directors in response to Covid-19. However, all of the directors' legal duties outlined in this note remain in place, and administrators and liquidators will retain the ability to seek to hold directors to account, where breaches of these duties have occurred.

Directors of companies which end up in administration or liquidation, who have acted in breach of their duties, also face the risk of action being taken to disqualify them from acting as company directors for up to 15 years, together with the potential of a compensation order being made against any individuals disqualified.

Do directors of companies providing 'Essential Services' for responding to the Covid-19 outbreak have new or different legal duties?

Many countries, including the UK, are now starting to relax certain aspects of their insolvency laws in response to the pandemic. However in the UK, no special measures have been implemented which apply only to the directors of companies providing Essential Services.

So, the fact that Essential Services are being provided does not mean that directors can, or must, continue to trade their business at any cost – they must still assess the position in the usual way and in line with the principles set out in this note.

However, the wider impact on the community is one of the factors required to be taken into account by directors when making decisions. It is highly likely that decisions taken by boards of companies undertaking Essential Services in the wider public interest will be scrutinised with more sympathy than prior to the arrival of Covid-19, at least when assessing the reasonableness of their actions in the circumstances.

Should all directors be taking advantage of any new funding being made available in response to Covid-19?

Directors must be considering all options available to their company, including the possibility of taking on new debt.

Increasing liabilities might provide the company with the financial firepower required to deal with the effects of Covid-19. But, before taking on new credit, the directors must be comfortable (exercising their commercial judgment and using all available evidence and advice) that the company will be able to repay that debt when it falls due for payment.

Despite the support which is available at this time, the prevailing uncertainty around the duration of the pandemic in the UK and across the world will make that a very difficult decision to make in many cases.

Despite much of it being underwritten by HM Government, much of the additional financial support being made available to UK businesses will be subject to satisfying existing lending criteria. As a result, it is unlikely to be available to businesses which were already experiencing financial distress.

The Government has ordered my business to close – what next?

Board members must use their skill and judgment to best deal with each of the consequences of the closure. Directors' duties are not suspended or postponed even in such difficult circumstances and directors must consider carefully what liabilities may continue to accrue while the business is closed.

Directors must consider all possible options. It may well be a viable option to 'mothball' some businesses for a period of time, rather than moving straight to a formal insolvency process. This may allow the company to take advantage of the Job Retention Scheme while requesting assistance or forbearance from landlords and/or other financial stakeholders.

Do the directors each understand their role, responsibilities and duties?

If a company enters a formal insolvency process, the actions of its board and the individual directors will always be considered and scrutinised with the benefit of hindsight.

Each of the directors needs to understand the extent of their duties and how these duties change when the company's solvency is in question.

Covid-19 is presenting unprecedented challenges to boards. To discharge their legal duties, directors are expected to use their skill and judgment as well as their experience of their businesses and the markets within which they operate.

Is there a turnaround plan in place?

Simply monitoring a company's financial position is not enough. Directors must give priority to devising and implementing a strategy for restoring the company to a stable and profitable position.

With Covid-19, this is made very difficult by the constantly changing and unpredictable environment. But other countries are already starting to show signs of more normal business life returning.

Is the board holding regular meetings?

Board members must remain in close contact and should speak regularly to enable informed decisions to be made about future steps. With the speed of movement in current events, this might be at least weekly, with informal discussions taking place more regularly in between.

Is there an audit trail?

Any liquidator or administrator will be obliged to review the actions of the directors in the period leading up to the formal insolvency process. A complete audit trail of the decisions and reasons for

those decisions may provide vital evidence that the directors have acted fully in accordance with their duties and responsibilities.

As a result, all board decisions should be carefully documented.

Should the board keep key creditors informed?

Directors must not mislead creditors about the company's financial position when incurring credit.

However, directors often face the conundrum of whether to inform certain key creditors in order to obtain their support for a turnaround but, in so doing, may risk individual action being taken which jeopardises the chances of success. The right approach will depend on the circumstances.

In many cases, particularly with sophisticated lenders, there may be no choice for the board but to engage. The company will often be under a contractual obligation to inform the lender of insolvency and any other material risks and events, and in many cases, the turnaround plan may be incapable of delivery without informed lender support.

A company's underperformance may - and its insolvency almost certainly will - trigger defaults in financial and other covenants in its finance documentation. Breach of a covenant may entitle a lender to make demand for immediate repayment. Where a breach has occurred, or it is anticipated that a breach may occur, it is important to contact the lender(s) and, where possible, negotiate a formal waiver.

Lenders are under no obligation to support all customers, even where Government guarantees are available, but it may be in their best interests to do so. The attitude of larger lenders is typically informed by a combination of market practice and reputational risk (lenders may be wary of being perceived to be over-zealous in the current climate), FCA/PRA regulatory requirements (such as Treating Customers Fairly), the terms of the governing loan and security documents and their trust in the underlying strength of their customer's business and that of its management team.

Covid-19 means that all commercial lenders are reporting high levels of customer contact. Remember that these are also unprecedented events for all business stakeholders.

How should customer deposits be treated?

Customer deposits should not be taken where the directors know (or ought reasonably to know) that the orders will not be fulfilled. Whether customers who pay by credit card may have other rights to recover deposits does not change that position.

As a minimum, where solvency is an issue, customer deposits should be paid into a separately identifiable account and not used as working capital. It may be possible to create a trust account to protect the deposits in the event of insolvency but this is not straightforward and the lender's agreement may be needed.

Are other creditors and key stakeholders being kept informed?

The company's external stakeholders are likely to include any institutional lender and HMRC. There may be other parties whose support is needed for the implementation of the company's turnaround strategy, for example, the trustees of a defined benefit pension scheme, or an overseas parent.

Key stakeholders must be kept informed of the progress of the turnaround strategy. The company's financial and legal advisers will be able to assist with this.

Is there a directors' and officers' insurance policy in place?

The terms of any insurance policy should be reviewed to ascertain the scope of the cover. Certain board actions may trigger a need to notify the insurers, and notifications should be made where required.

Should the directors resign?

Although the board of directors should act collectively, the threat of insolvency is a highly stressful situation and may lead to disagreements. It is particularly important to ensure that all discussions, however challenging, are carefully documented.

Sometimes it may be appropriate for a dissenting director to resign in protest against the board's collective decision. However, this will not relieve the departing director from liability for wrongful acts or omissions which took place during their term of office.

Directors who do resign may also be criticised for abrogating their duties and responsibilities at the very time when the company's creditors and other stakeholders need them most.

Do	Don't
▪ Take every step with a view to protecting creditors' interests - it is the duty of directors of insolvent companies to do so above all else.	▪ Trust to blind faith or ignore the problem in the hope that it will go away.
▪ Plan and act early.	▪ Trade on at the expense of creditors beyond the point of no return.
▪ Hold regular board meetings and communicate frequently.	▪ Mislead creditors or take credit without a reasonable expectation of it being repaid.
▪ Share information and voice any concerns to the board.	▪ Make payments/grant security without reasonable expectation of benefit to the company.
▪ Take insolvency advice from suitably qualified lawyers and accountants	▪ Put personal or other interests ahead of those of the company.
▪ Check D&O insurance policy triggers and notification requirements.	▪ Just resign without first exploring all available avenues to deliver the best outcome for creditors.
▪ Investigate, formulate, adopt and maintain a viable strategy in response.	▪ Assume that Covid-19 will mean that breaches of duty will be ignored.
▪ Plan for contingencies, including formal insolvency.	▪ Keep key stakeholders in the dark.

Contact us

Please contact us using the details below and we would be happy to set-up a video conference/call with you or your wider team.

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