

MACFARLANES

CORPORATE

BRIEFING

CORPORATE INSOLVENCY – ISSUES FOR DIRECTORS

FREQUENTLY ASKED QUESTIONS

I am a director of a company which may be about to go bust. What should I do?

That depends on why you think the company may be about to go bust and whether there is anything which can be done to prevent it. If the company is running out of cash, are there options available, perhaps involving refinancing, a formal insolvency procedure (such as administration or a voluntary arrangement) or other steps (perhaps a partial sale)? For a practical assessment you need to speak (urgently) to your accountants (if they have corporate recovery expertise), or to corporate recovery experts with whom we can put you in touch.

Should I resign?

Probably not. If the company may go into liquidation, your obligation as a director is to take every step which you ought reasonably to take with a view to minimising the potential loss to creditors. Failure to do so could leave you personally liable for wrongful trading (see below). Resigning will not help creditors.

What is wrongful trading?

If a company goes into insolvent liquidation and the liquidator can show that the directors allowed the company to continue trading after the point of no return, he may claim against the directors personally for a contribution towards the creditors' losses. The point of no return occurs where directors realise - or ought to realise - that there is no reasonable prospect of the company avoiding insolvent liquidation.

How can I avoid liability for wrongful trading?

By constantly testing whether the company has a "reasonable prospect" of avoiding insolvent liquidation. This means producing reliable cash flow forecasts, ensuring that the bank supports your continued trading (where this relies on an overdraft) and/or ensuring that the company retains the support of its investors (where continued trading will rely on further investment). If at any point there is no longer a "reasonable prospect", you (and the board) need to take every step which you ought reasonably to take in order to minimise the potential loss to creditors. This will almost certainly mean invoking a formal insolvency procedure of some kind and, in the meantime, ceasing to pay creditors or place new orders. Before you get to this stage, you ought already to have approached an insolvency practitioner who will be prepared to take over the business (whether on liquidation, administration or receivership) in order to ensure a smooth transition, avoiding a hiatus during which irreparable damage may be caused to the goodwill of the business.

The company owes me money. Can I repay this before the company goes into liquidation?

Any such payment may constitute a "preference" under the Insolvency Act. Not only will you risk having to repay the money, but you may also risk disqualification as a director. The Department of Business, Innovation & Skills, based on a report which the liquidator, administrator or receiver will prepare, may take proceedings for an order disqualifying you from being involved in the management of a limited liability company for up to fifteen years where you have been involved in actions which demonstrate "unfitness", such as preferring certain creditors, particularly yourself or those connected with you, over others.

The company owns assets which could be used by another company with which I am involved. Can these be transferred to protect them from the liquidator?

A company which is insolvent (ie unable to pay its debts as they fall due, or with negative net assets) cannot lawfully transfer assets except for full market value. Other transfers of assets may be reversed by a liquidator; or the person who acquires the assets may be required to pay full value for them. Directors who approve transfers at an undervalue may be guilty of wrongful trading or breach of duty and will be exposed to the risk of disqualification.

I have heard that it is possible to put a company into administration and set up a new company to buy the business from the administrator. Is this an option?

It may be an option, but the new company will have to pay full value for the business. The administrator (or liquidator) has a duty to get the best price he can for the company's assets. It is not uncommon for existing management to be able to offer the best price, particularly if a quick deal is necessary in order to avoid loss of a fragile customer base or workforce, or where personal contacts are particularly important. There are, though, restrictions on the ability of the directors to carry on a new business under the existing company's name, or a similar name. Certain exemptions are available.

What is a 'pre-pack' administration?

A pre-packaged administration is a procedure for selling the business of a financially precarious company in order to preserve its value and avoid a damaging period of trading whilst in formal insolvency. The company negotiates the proposed terms of sale with a prospective buyer (whether independent or connected with the existing owners or management) and prospective administrators. Once the sale documentation has been agreed, the company appoints the administrators and they sign the pre-agreed sale agreement. Besides preserving value, this procedure can protect directors against allegations of

selling at an undervalue and preferring certain creditors (those transferred to the buyer) over others (those left behind). In some cases it may be the only realistic option for achieving a going concern sale (and maximising sale value), for example where no funds would otherwise be available to enable administrators to continue trading the business following their appointment.

If the company goes into liquidation, administration or receivership, will I have any continuing obligations?

This will depend to some extent on the nature of the insolvency procedure, but broadly speaking your duties (and powers) as a director will cease. The liquidator/administrator/receiver may well want you to continue working in the business if he is seeking to sell it as a going concern, and he will in any event require you to provide information and assistance to enable him to carry out his functions. There are statutory powers to compel directors to provide information (which can include questions aimed at establishing whether the directors have been guilty of wrongful trading). Insolvency practitioners generally have a standard questionnaire which they will ask directors to complete. You might want our advice before completing this.

I have D&O cover – if my company becomes insolvent am I protected?

D&O policies typically provide cover for liabilities related to insolvency unless expressly excluded. But D&O cover is commonly provided on a 'claims made' basis. Liquidators and administrators are unlikely to maintain cover for former directors, so it may be necessary to consider purchasing 'run-off' cover, although this may be expensive. In any event, you should consider whether past actions which might expose you to the risk of claims following insolvency and, if appropriate, make a precautionary notification to the insurers under the existing policy. A blanket precautionary notification is unlikely to satisfy the insurer, so particular risks should be specifically identified.

Macfarlanes publishes a more detailed practice note entitled "Companies in Financial Difficulty - Practical Issues for Directors" which considers these and other topics of relevance to directors of UK companies facing the prospect of insolvency. Copies may be obtained by writing to the Marketing Department, Macfarlanes, 20 Cursitor Street, London EC4A 1LT or visit our website at www.macfarlanes.com

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