MACFARLANES

ISSUES FOR DIRECTORS OF LISTED COMPANIES IN FINANCIAL DIFFICULTY

INTRODUCTION

Being involved with a company which is experiencing financial difficulties is clearly a stressful experience for directors. As well as having to deal with the operational consequences of the company's distress, directors must ensure that they comply with their duties and obligations under the Companies Act 2006 (CA2006) and the Insolvency Act 1986 (IA1986). Directors of listed entities are in a particularly difficult position, as in addition to those duties they must comply with their obligations to the markets.

DIRECTORS' DUTIES

Pursuant to section 172(1) of the CA2006 a director must act in the way he considers, in good faith, would be most likely to promote the success of the relevant company for the benefit of its members as a whole.

Section 172(3) provides that the duty imposed by section 172(1) has effect "*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*". Several cases have since determined that where a company is insolvent or on the verge of insolvency, the directors owe a duty to act in the best interests of creditors. This is perhaps best articulated in the following statement of Street CJ in *Kinsela & Anor v Russell Kinsela Pty Ltd (in liquidation)* [1986] 4 NSWLR 722:

"*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 the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets*."

Liability for a failure to maintain this duty is enshrined in section 212 of the IA1986, whereby a liquidator may bring an action for misfeasance against directors who have breached their duty to creditors. Directors must also take steps to avoid liability under various other provisions of the IA1986. The most obvious is an action under section 214 for "wrongful trading", whereby a director of a company who knew, or should have known, that the company had no reasonable prospect of avoiding insolvent liquidation must take all steps with a view to minimising losses to creditors. A successful challenge can have severe consequences for the director concerned, ranging from an adverse "D report" in relation to his conduct to personal liability for any losses caused to creditors as a consequence of a failure to take such steps in those circumstances.

RELATIONSHIP BETWEEN DIRECTORS' DUTIES AND REPORTING OBLIGATIONS

It is clear that directors of companies which are on the brink of insolvency must be primarily concerned with the impact which their decisions may have on creditors. However, there is something of a conflict between such concerns and the obligations of the directors to make announcements to the markets for the benefit of current and prospective shareholders.

Companies admitted to trading on EU regulated markets in the UK (referred to in the legislation as "issuers") must comply with the Disclosure and Transparency Rules (DTRs) made by the Financial Conduct Authority (FCA) (similar regimes exist on other markets). Pursuant to DTR 2.2.2:

"*An issuer must notify a RIS [a stock market notification] as soon as possible of any inside information which directly concerns the issuer…*"

"Inside information" is, broadly, information, which:

- is not generally available;
- relates directly or indirectly to the issuer or its shares; and
- would, if generally available, be likely to have a significant effect on the price of its shares.

The third part of the test is predicated on the "reasonable investor" test, which FCA guidance states is a test that the issuer should apply to determine the likely significance of the information. The test is:

"<u>*whether the information in question would be likely to be used by a reasonable investor as part of the basis of his investment decisions*</u> *and would therefore be likely to have a significant effect on the price of the issuer's financial instruments*" (DTR 2.2.4 G).

The FCA, in applying this test in practice, has tended to focus on the underlined text.

The requirement in the DTRs is drawn from EU Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (the Market Abuse Directive). Recital 24 of the Market Abuse Directive sets out some of the reasoning behind it:

"*Prompt and fair disclosure of information to the public enhances market integrity, whereas selective disclosure by issuers can lead to a loss of investor confidence in the integrity of financial markets*."

The disclosure regime addresses wider issues than the relationships between an issuer and its shareholders and creditors. It instead exists to ensure that there is a "level playing field" so that investors do not sell or purchase securities in circumstances where there is material information about which they do not know that would affect their investment decision. It is not difficult to think of circumstances that would rapidly lead to a general loss of confidence in capital markets if the regime did not exist.

It is therefore no surprise that the disclosure regime does not contain a general carve-out for announcements which would breach directors' duties. The regime does, however, allow disclosure to be delayed in certain circumstances. DTR 2.5.1 provides that:

"*An issuer may, under its own responsibility, delay the public disclosure of inside information, such as not to prejudice its legitimate interest provided that:*

1. *such omission would not be likely to mislead the public;*
2. *any person receiving the confidential information owes the issuer a duty of confidentiality, regardless of whether such duty is based on law, regulations, articles of association or contract; and*
3. *the issuer is able to ensure the confidentiality of that information*."

The principal application of avoiding prejudicing "legitimate interests" is to negotiations. DTR 2.5.2(1) makes clear that there is a legitimate interest in relation to:

"*negotiations in course, or related elements where the outcome or normal pattern of those negotiations would be likely to be affected by public disclosure. In particular, in the event that the financial viability of the issuer is in grave and imminent danger, although not within the scope of the applicable insolvency law, public disclosure of information may be delayed for a limited period where such a public disclosure would seriously jeopardise the interest of existing and potential shareholders by undermining the conclusion of specific negotiations designed to ensure the long term financial recovery of the issuer*."

This duty however:

"*does not allow an issuer to delay public disclosure of the fact that it is in financial difficulty or of its worsening financial condition and is limited to the fact or substance of the negotiations to deal with such a situation. An issuer cannot delay disclosure of inside information on the basis that its position in subsequent negotiations to deal with the situation will be jeopardised by the disclosure of its financial condition*" (DTR 2.5.4 G).

Of particular concern will be the potential erosion to the value of the company's business and assets that an announcement would be likely to cause, as well as alerting the market that the company may soon enter an insolvency process. Dealings with suppliers will become almost impossible, employee morale will plummet and debtor collections will become far more difficult. Shareholders may be therefore left with shares whose value falls significantly, notwithstanding the fact that the company is in negotiations with its lenders about providing additional funding. That notwithstanding, the disclosure regime is very clear. The company's financial difficulty must be announced to the market immediately (although it can delay the announcement of its negotiations with its lenders). In other words, general duties to shareholders and creditors are overridden by specific rules around the importance of maintaining confidence in the capital markets. However, directors will also be careful to avoid making an announcement later than necessary, and being accused of misleading the market by doing so.

The FCA is granted extensive powers for breaches of the disclosure and market abuse regimes. It could issue significant fines, which in itself would be harmful to the interests of creditors, from a directors' duties perspective. It is also authorised to suspend, prohibit, order injunctions, bring criminal prosecutions or take other action to prevent market abuse and make a public announcement when it begins disciplinary action against a firm or individual and publish details of warning notices.

CONCLUSION

Although directors' duties change when a company is in financial difficulty, a listed company's disclosure obligations do not, and there is therefore a tension between the competing interests of creditors against the regulatory requirement for transparency. It is difficult to see, from a public policy perspective, a scenario where a court would hold that directors were in breach of their duties to act in creditors' interests as a result of having procured that the issuer comply with specific legal and regulatory obligations, but this must be very carefully managed.

Directors of listed companies will, therefore, wish to avoid liability towards the FCA as well as under the provisions of the IA1986 set out above and should, therefore:

- take legal advice;
- ensure lenders are aware of the company's disclosure obligations, and the possible consequences of an early / late announcement;
- have the wording for any possible announcement prepared and ready to be issued at short notice;
- minute decisions and keep records of discussions with lenders and advice received as well as discussions of whether to announce or not and have a full audit trail supporting those decisions; and
- take advice from the sponsor (full list) / NOMAD (AIM) on the application of the DTRs / AIM Rules.

In situations where creditors are themselves regulated by the FCA, and required under regulation to conduct business with integrity, with due skill, care and diligence and to observe proper standards of market conduct, there ought to be a common interest from a compliance perspective. However, again, dialogue to ensure that disclosure obligations are properly understood will be vital.

CONTACT DETAILS
If you would like further information or specific advice please contact:

JAT BAINS
PARTNER
RESTRUCTURING AND INSOLVENCY
DD: +44 (0)20 7849 2234
jat.bains@macfarlanes.com

SIMON BEALE
SENIOR COUNSEL
RESTRUCTURING AND INSOLVENCY
DD: +44 (0)20 7849 2237
simon.beale@macfarlanes.com

PAUL KEDDIE
SENIOR SOLICITOR
RESTRUCTURING AND INSOLVENCY
DD: +44 (0)20 7849 2894
paul.keddie@macfarlanes.com

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MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT
T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com