DIRECTORS' LIABILITY IN THE TWILIGHT ZONE

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NVRII

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Executive Summary for NVRII Report

Outline of the Report

In 2013 the UNCITRAL Legislative Guide[1] acknowledged that the nature and extent of the obligations directors might have in the period when the business might be experiencing financial distress but is not yet insolvent or subject to insolvency proceedings (*i.e.*, 'in the zone of insolvency') are not well established. They are, however, increasingly the subject of extensive debate, particularly in view of the widespread failures following the global financial crisis of 2008. The debate continues and this report:

a. provides in Parts 1-3 an English law perspective on directors' liability in the zone of insolvency;
b. addresses a number of specific questions in Part 4; and
c. ends in Part 5 with a brief discussion of Article 18 (regarding duties of directors) of the proposed Directive on Preventive Restructuring Frameworks[2] and an initial assessment of whether relevant English law can be considered compliant with this article (assuming it would apply to the UK).

Rescue Culture

Under English law, directors' duties are derived from common law and equitable principles, but they are also codified in the Companies Act 2006 (CA 2006).[3] The UK embraces the so-called 'rescue culture', when considering directors' liabilities in the zone of insolvency.[4] In general terms, this means that directors should be given sufficient flexibility so as to allow them, without unnecessary fear for personal liability or excessive caution, to make an honest attempt to try and rescue the company or its business. Ceasing to trade and liquidating too soon can be stigmatized as the 'cowards' way out', undermining the rescue culture.

1 *See UNCITRAL Legislative Guide on Insolvency Law – Part four: Directors' obligations in the period approaching insolvency* ("UNCITRAL Legislative Guide"), United Nations Commission on International Trade Law, 2013, Chapter I (Background) at para. 3.
2 For a brief discussion of the Proposal and an initial assessment of its Art. 18, *see* Part 5 of this report.
3 *See* in particular Sections 171-177 CA 2006, which are briefly addressed in Sections 1.2-1.4 of this report.
4 The 'rescue culture' is specifically addressed in Section 2.10 of this report. See also Section 4.3.1(b) of this report.

Creditors' Interests Paramount in the Zone of Insolvency

It is further important for directors to take account of the fact that under English law, when the company enters the zone of insolvency, the focus of the directors' duties changes.[5] In the zone of insolvency, the interests of the creditors become paramount over those of the members/shareholders of the company. This shift in focus strongly colors how directors' conduct and actions in the zone of insolvency are assessed. It is therefore essential for directors to know when they are in the zone of insolvency. While case law does provide some guidance,[6] it unfortunately is rather imprecise. When exactly a duty to consider the interests of the creditors arises will therefore have to be determined on a case-by-case basis.

Focus on Wrongful Trading

A breach of one or more of the directors' duties could result in directors' liability based on misfeasance. A simplified procedure and statutory remedy for misfeasance is contained in Section 212 of the Insolvency Act 1986 (IA 86). The concept of misfeasance, together with a number of other relevant concepts under English law that directors should keep in mind when acting in the zone of insolvency (including a number of grounds on the basis of which transactions might be avoided (*e.g.*, transactions at undervalue and preferences) and possibly disqualification under the Company Directors' Disqualification Act 1986), are only briefly touched upon in Part 3 of this report. The focus of the report is, however, on the concept of wrongful trading as set forth in Section 214/246ZB IA 86.

Directors Covered by Wrongful Trading[7]

Wrongful trading is a 'fault'-based liability[8] that applies to both directors and shadow directors of companies that at some point have gone into insolvent liquidation or insolvent administration. A director is any person occupying the position of director by whatever name called (*i.e.*, both *de jure* and *de facto* directors). A shadow director, on the other hand, is a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow

5 *See* in particular Section 1.3 of this report.
6 *See* in particular Sections 1.5-1.8 of this report.
7 *See* in particular Section 2.2 of this report.
8 More generally, for a useful list of examples of behaviour by directors that could constitute a fault in management, *see* UNCITRAL Legislative Guide, *supra* note 1, Chapter II (Elements of directors' obligations in the period approaching insolvency) at para. 21.

director by reason only that the directors act on the advice given by that person in a professional capacity).[9]

The 'No Reasonable Prospect' Requirement[10]

As part of the 'rescue culture' embraced in the UK, there is no firm duty on directors to file for insolvency proceedings at a certain predetermined point in time. The concept of wrongful trading functions in practice as a compass for directors to assess if and when trading should stop. The idea behind wrongful trading is that, at some point in time prior to the commencement of insolvency proceedings, the (shadow) director knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation or insolvent administration. When this so-called 'no prospect' requirement is met, the continuation of trading is deemed wrongful. There is both an objective and subjective standard, using a reasonably diligent person having general knowledge, skill and experience, to assess whether the 'no reasonable prospect' requirement is met. Again, while case law does provide imprecise guidance, this really requires a case-by-case determination. For a director it is important to expressly raise the 'no reasonable prospect' question and consider it directly, closely and frequently. In short, it cannot be ignored.

The 'Every Step' Defense[11]

When the 'no reasonable prospect' requirement is met, liability based on wrongful trading can still be avoided by a (shadow) director who can demonstrate that from that point in time onwards he/she took every step with a view to minimizing loss to the company's creditors as he/she ought to have taken. The threshold for successfully invoking this defense is high and also features an objective as well as a subjective standard.

Duty to Contribute[12]

If the 'no reasonable prospect' requirement is met, but the directors continue to trade and are unable to rely on the 'every step' defense, then the Court has discretion to determine, as it thinks proper, the contribution a director must make based on wrongful trading liability. The starting point for determining the required contribution is that there must

9 According to *Sealy & Milman: Annotated Guide to Insolvency Legislation 2017* (20th edition), Volume 1, commentary to Section 212(1) IA 86, p. 220, the better view is that shadow directors are not within Section 212 IA 86 for a misfeasance claim.

10 *See* in particular Sections 2.4 and 2.5 of this report.

11 *See* in particular Sections 2.6-2.8 of this report.

12 *See* in particular Section 2.9 of this report.

be an increase in the net deficiency of the company which reflects the loss to the company as a result of the commencement of the liquidation/administration proceedings being delayed. The contribution is compensatory in nature, rather than penal.

Essential Practicalities[13]

So what should directors in the zone of insolvency do? Although not a shield for directors' liability, English Courts do place some reliance on independent professional (specialist insolvency) advice directors have obtained. It is therefore prudent for directors to timely involve specialist advisors, both financial and legal. When in or close to the zone of insolvency, it is further prudent for directors to keep a detailed written record and hold regular full board meetings to consider the company's financial position with detailed minutes reflecting discussions, options considered, plans, projections, assumptions and providing fully reasoned explanations for decisions made.[14]

Peter J.M. Declercq
London, 28 November 2017

13 *See* in particular Sections 2.6 and 4.2(e) of this report.

14 For a list of other adequate and appropriate steps directors in the zone of insolvency may, depending on the facts and circumstances of the situation at hand, wish to consider, see UNCITRAL Judicial Guide, *supra* note 1, Chapter II (Elements of directors' obligations in the period approaching insolvency) at para. 5.

4th Floor, 30 Broadwick Street
London W1F 8LX, UK

t: +44 203 941 6045
www.dcqlegal.com

For a copy of the entire chapter "An English Law Perspective of Directors' Liability in the Zone of Insolvency" by Peter J.M. Declercq, please send us an email to info@dcqlegal.com.