Insolvency and directors' duties – the simplified new regime?

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WHEN ANY NEW LEGISLATION IS INTRODUCED, lawyers, at the very least, will ensure that they are up to speed on the impact it will have on their area of law. The introduction of an Act that comprises 1,300 sections (the longest-ever piece of legislation) and has a significant effect on the day-to-day activities of companies is of direct interest, however, not only to lawyers, but also to directors and senior management.

When the government announced the detailed timetable for the implementation of the Companies Act 2006 in February 2007, many were relieved to see that the various sections were to be implemented in stages. Those that took this as an opportunity to delay getting up to speed, however, will now have their work cut out, as the first of the major provisions – the codification of directors' duties – has now come into force. The time has come to ascertain how the new provisions work in practice, especially with regard to a company facing insolvency.

DIRECTORS' DUTIES

Previously, directors' duties were not codified in statute but were derived from equitable principles and common law rules.

On 1 October 2007 the majority of Part 10 of the Act came into force. The provisions (ss170 to 177) not only codify but also expand upon the current equitable and common law duties, with the aim of clarifying directors' responsibilities in a statutory statement. These duties are set out as:

- a duty to exercise independent judgment;
- a duty to exercise reasonable care, skill and diligence;
- a duty to avoid conflicts of interest;
- a duty not to accept benefits from third parties; and
- a duty to declare an interest in a proposed transaction or arrangement.

Directors will, no doubt, already be aware of these duties and, consciously or subconsciously, will be considering them in their everyday decisions.

FACTORS TO BE CONSIDERED

In addition to the above duties, the Act introduces a requirement for directors to act in a way which they consider in good faith would be most likely to promote the success of the company for the benefit of its members as a whole (s172). The Act states that, in fulfilling this duty, directors must have regard to:

1) the likely consequences of any decision in the long term;

2) the interest of the company's employees;

3) the need to foster the company's relationships with suppliers, customers and others;

4) the impact of the company's operations on the community and the environment;

5) the desirability of the company maintaining a reputation for high standards of business conduct; and

6) the need to act fairly as between members and the company.

It is at this point that directors may raise an eyebrow. A director balances numerous issues when making decisions and those issues are likely to be different from company to company. For the first time, however, directors are being told what factors they must take into account. What if certain factors have never been considered before? What if some of the factors are completely irrelevant?

At various stages of the consultation process the government was keen to stress that directors retain the right to decide how much weight is given to each factor. If it is deemed appropriate, one particular factor may be dismissed completely.

However, given the existence of the shopping list of factors, it appears that, whilst the destination may be the same, the path that directors must now take to reach decisions may be very different.

A COMPANY IN DIFFICULTY

The government clearly recognised that the fairly rigid list of duties and factors set out above simply does not work if a company is faced with a potential insolvency situation. As a result, s172(3) provides a carve-out to the duty to promote success for the benefit of members by providing that the duty is:

> '... 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.'

It has always been the case that directors have an overriding duty to creditors in an insolvency situation. Directors who were expecting the legislation to make it easier for them to know how

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to discharge their duty and, in turn, protect their personal position are unfortunately left disappointed. Far from making the factors that should be considered simpler and easier to determine, the legislation has left a number of uncertainties in place.

First, the age-old issue of determining whether a company is insolvent remains. Unlike a number of other jurisdictions, England has two independent tests:

1) the cash flow test – that the company cannot meet its debts as and when they fall due; and

2) the balance sheet test – that the company's liabilities exceed its assets.

The necessity for directors to obtain specialist advice as to the financial position of the company remains as crucial as ever. If the company is not insolvent, their duty is owed to members under s171. If the company is insolvent, their duty is owed to creditors under s172(3). It remains difficult for directors to know precisely when creditors' interests are to be preferred over the interests of shareholders, and there is no neat dividing line. It also seems unlikely that any further guidance will be issued that will make this particular decision any easier to make.

If a director concludes or ought to conclude that there was no reasonable prospect of avoiding insolvent liquidation, but continues to trade on regardless, then the director may be personally liable for further debts incurred. When considering the factors set out in s172(1), directors are naturally going to err on the side of self-preservation if there is even the smallest possibility that they could face personal liability. As a result, will directors be too eager to decide that they owe their duty to creditors as opposed to shareholders? If they make this decision too hastily, will they leave themselves exposed to a claim by shareholders that they have not fulfilled their duty under s172?

The factors set out in s172(1) are not exhaustive and directors must still have regard to equitable principles and common law rules. In this regard, the new Act has not simplified the decision-making process. The fact, however, that the Act specifically lists some of the factors, and states that directors should have regard to them, will create an environment where risk-averse directors will feel a natural and understandable desire to record the reasons behind their decisions by undertaking a box-ticking exercise, even though the government stated that this was not its objective. Directors will want to record that the factors did form part of their thought process, even if they were immediately dismissed. Therefore, it is likely that board minutes will be longer and more detailed than before.

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PRACTICAL STEPS

So what steps, amongst others, should a director take to protect their position when faced with a company in an insolvent situation?

1) The director must first determine if they are actually facing a potential insolvency situation and, if so, whether the business is viable. This will involve obtaining specialist insolvency advice. Case law has shown that directors who have taken and acted upon advice are less likely to be criticised for steps that they did or did not take even if, in hindsight, those steps were incorrect.

2) The need to ensure that there is a comprehensive paper trail is even greater following the introduction of the new Act. Despite the government's remarks, it will be a brave director who does not record in full the decision-making process even where factors were not relevant.

CONCLUSION

The introduction of the new legislation will no doubt, at least initially, cause some confusion and concern for directors. Until a number of directors' disqualification cases have been heard by the courts, however, practitioners will not be able to gauge with any degree of certainty the effect that the new Act will have on directors' duties. It is clear that, although some of the terminology has changed, the old common law rules and equitable principles remain. As a result, and until the new legislation has bedded down, directors are likely to need specialist advice as to whom their duties are owed and how they are to be discharged.

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