Obligations placed on directors of potentially insolvent companies

Wrongful trading – s 214 Insolvency Act 1986

A court can order a director personally to make a contribution to the company if it finds that once he or she knew, or should have known, that the company could not avoid insolvent liquidation, the director did not take every step to minimise the loss for creditors that he or she should have taken. Such steps could include:

- Not taking further credit unless arrangements are made to ensure it is paid.
- Not continuing to trade unless it is clearly in the interests of creditors to do so, eg because a cash surplus would be generated from trading or for work in progress to be completed.
- Not allowing assets, including goodwill, to dissipate.
- Nor allowing one creditor to benefit, say from a payment, to the detriment of the others.

Only a liquidator can start a wrongful trading action, not a receiver, administrator or supervisor of a company voluntary arrangement.

Legal actions are expensive and liquidators can be responsible for costs if they lose. They therefore take into account the size of creditors' loss and likely recovery when deciding whether to take an action. Successful court actions are rare but settlements out of court are more common. Liquidators would tend to pursue those with deep pockets and not those without assets, whatever the severity of the loss. Directors can be disqualified for wrongful trading even though the liquidator has decided not to pursue a civil action.

In addition to a financial settlement and possible disqualification, there could be adverse publicity for directors following a wrongful trading action

A liquidator can include former directors in his investigations if they were directors at the time the company was in financial difficulties. Simply resigning as director does not absolve a director from responsibility for wrongful trading (unless perhaps he is in a minority and the other directors are acting contrary to his wishes). Resigning could actually make the position worse since the director could still be judged on the action he could have taken if he had not resigned.

Wrongful trading could also apply to shadow directors. A shadow director is someone in accordance with whose instructions a company is accustomed to act. A shadow director could include a corporation.

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Obligations placed on directors of potentially insolvent companies

Fraudulent trading – s213 Insolvency Act 1986

If a liquidator believes that any business of the company was intended to defraud creditors or for any fraudulent purpose, then he can apply to the court that any persons who knowingly participated in this should make a contribution to the company's assets.

Similar practical issues apply to this section as to wrongful trading as discussed above.

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Criminal acts by directors of insolvent companies

Fraud etc in anticipation of winding up – s206 Insolvency Act 1986

Any past or present officer (including shadow director) of the company has committed a criminal offence if, within the twelve months before the commencement of compulsory or creditors' voluntary liquidation and afterwards, he has intentionally done, or has been privy to others doing, the following.

- Concealed any part of the company's property to the value of £500 or more, or concealed any debt due to or from the company.
- Fraudulently removed any part of the company's property to the value of £500 or more.
- Concealed, destroyed, mutilated or falsified any book or paper affecting or relating to the company's property or affairs.
- Made any false entry in any book or paper affecting or relating to the company's property or affairs.
- Fraudulently parted with, altered or made any omission in any document affecting or relating to the company's property or affairs.
- Pawned, pledged or disposed of any property of the company that has been obtained on credit and has not been paid for (unless the pawning, pledging or disposal was in the ordinary way of the company's business). (In this case, any party receiving the property knowing this clause to be breached also commits an offence).

Anyone who is found guilty under this section is liable to imprisonment or a fine, or both.

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Criminal acts by directors of insolvent companies

Transactions in fraud of creditors – s207 Insolvency Act 1986

When a company is in compulsory or creditors' voluntary liquidation, an individual who at the time was an officer of the company has committed an offence if he intentionally took the following steps with a view to defrauding the creditors.

- In the five years before liquidation, he was involved in the gift or transfer of, charge on or execution against the company's property.
- He has concealed or removed any company property in the period starting from two months before the date of any unsatisfied judgment or order for the payment of money obtained against the company.

Anyone who is found guilty of an offence under this section is liable to imprisonment or a fine, or both.

Misconduct in course of winding up – s208 Insolvency Act 1986

When a company is in compulsory or creditors' voluntary liquidation, any past or present officer of the company commits an offence if he intentionally does the following.

- Does not, to the best of his ability, fully and truly disclose to the liquidator all the company's property and account to him for the disposal of any such property outside the normal course of business.
- Does not deliver up to the liquidator company property that he possesses or is under his control and that he is required by law to deliver up.
- Does not deliver up to the liquidator all books and papers of the company that he possesses or is under his control and that he is required by law to deliver up.
- Fails to inform the liquidator when he knows or believes that anybody has proved a false debt in the liquidation.
- Prevents any book or papers that are relevant to the company's property or affairs being produced.
- Attempts to account for any part of the company's property by fictitious losses or expenses, including doing so at any creditors' meeting in the twelve months before liquidation.

Anyone who is found guilty of an offence under this section is liable to imprisonment or a fine, or both.

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Criminal acts by directors of insolvent companies

Falsification of company's books – s209 Insolvency Act 1986

When a company is in liquidation, an officer or contributory commits an offence if he destroys, mutilates, alters or falsifies any books, papers or securities, or makes or is privy to the making of any false or fraudulent entry in any register, book of account or document belonging to the company with the intent to defraud or deceive any person.

Anyone who is found guilty of an offence under this section is liable to imprisonment or a fine, or both.

Material omissions from statement relating to company's affairs – s210 Insolvency Act 1986

When a company is in compulsory or creditors' voluntary liquidation, any past or present officer of the company, including a shadow director, commits an offence if he intentionally makes any material omission in any statement of the company's affairs, or if he intentionally made such a material omission in any statement prior to liquidation.

Anyone who is found guilty of an offence under this section is liable to imprisonment or a fine, or both.

False representation to creditors – s211 Insolvency Act 1986

When a company is in compulsory or creditors' voluntary liquidation, any past or present officer of the company, including a shadow director, commits an offence if he has previously made, or subsequently makes, any false representation or commits any other fraud for the purpose of obtaining creditors' consent with reference to the company's affairs or to the liquidation.

Anyone who is found guilty of an offence under this section is liable to imprisonment or a fine, or both.

Prosecution of delinquent officers and members of the company – s218 Insolvency Act 1986

If during liquidation a court finds that any past or present officer or any member of the company has been guilty of any offence in relation to the company for which he is criminally liable, it may direct the liquidator to refer the matter to the Secretary of State

If a company is in compulsory liquidation and a liquidator other than the Official Receiver is acting and becomes concerned that any past or present officer or any member of the company

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Criminal acts by directors of insolvent companies

has been guilty of an offence in relation to the company for which he is criminally liable, then he has to report the matter to the Official Receiver.

If a company is in creditors' voluntary liquidation and the liquidator becomes similarly concerned as above then he has to report the matter to the Secretary of State. If a court believes that a liquidator has failed to make such a report, it can require him to do so. The liquidator also has to co-operate with the Secretary of State by supplying him with such information, documents and facilities as he requires. The Secretary of State may then exercise his powers under the Companies Acts to investigate the company's affairs.

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Ensuring that the creditors are treated equitably

Transactions at an undervalue – s 238 Insolvency Act 1986

A court can overturn a transaction undertaken by a company that it finds was completed for no consideration or for a value significantly below the benefit obtained by the company.

Only a liquidator or an administrator can start an action, not a receiver or a supervisor of a voluntary arrangement.

An action can only be taken in respect of transactions completed within a two-year period before insolvency and where the company was insolvent at the time or became insolvent as a result of the transaction. Where the parties are connected, there is a presumption of insolvency at the time.

The giving of a guarantee without proper consideration can be a transaction at an undervalue.

There are defences if the transaction was in good faith and during the normal course of business, or if at the time there were reasonable grounds for believing it would benefit the company.

The insolvency practitioner would be liable for costs if his action failed. He would not therefore take an action unless the transaction was material and there was a reasonable prospect of success. This does not stop the DTI seeking to disqualify a director for a transaction at an undervalue.

If the board decides to sell the whole business or certain assets outside insolvency, whether to third parties or to companies in the same group, it should ensure it could demonstrate that the company obtained a fair market price under the circumstances. Where a proper marketing campaign is not possible or would be commercially disadvantageous, then for their protection directors should obtain advice from professional valuers and suitably experienced insolvency practitioners.

Whilst these provisions are usually applied to disposals between connected parties, they do not prohibit a sale to existing directors, employees or group companies. It is only necessary to ensure that the price is fair. In many cases, a management team is best placed to move quickly and offer the best price. It is however important to demonstrate that other interested parties were afforded as much time and information as practical in the circumstances to allow them to compete effectively.

The directors should beware of selling the business as a going concern for a price that is below the sum of the break up values of the individual assets or businesses.

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Ensuring that the creditors are treated equitably

Intangible assets such as goodwill are not excluded from these provisions. The valuations are more subjective however and are best proven by active marketing of the business. It is accepted that the urgency created by insolvency might depress values of the business goodwill.

Once a potential disposal opportunity has been negotiated, it would help to safeguard the directors and the purchaser if an independent insolvency practitioner were to be consulted, either to advise on the completion of the transaction before any insolvency procedure is started, or to continue the negotiations in the context of an insolvency procedure.

This provision is not about establishing criminal intent but about fairness to creditors when there are insufficient assets to repay them in full. The court's remedy is simply one of reinstating the position to that before the transaction, or otherwise requiring a further payment. There are separate criminal provisions where the transaction was so deliberate, blatant or severe as to intend to put assets beyond the reach of creditors, which represents fraud. The DTI does however include transactions at undervalues as events that could be grounds for disqualification.

Preferences – s 239 Insolvency Act 1986

A court can order a creditor to repay all or part of a settlement of his debt made shortly before insolvency if it finds that the directors intended to prefer him (ie put him in a better position than in a liquidation).

- Where the creditor is a connected party, there is an inference that there was an intention to prefer and the company was insolvent at the time. It is for the creditor to prove otherwise.

- A settlement includes a giving of a charge to secure a debt as well as a payment. It can also include payment or partial payment of a debt the creditor has guaranteed.

- Any attempt by the directors to make a cash payment against existing loans, or to take over individual assets or the whole business in lieu of these loans, will potentially fall foul of this provision.

Action can only be taken where the preference takes place in the six months preceding insolvency - or two years in the case of a connected party – and the company was insolvent at the time or became insolvent as a result of the preference.

Payments to suppliers in the normal course of trade or in response to a threat of legal recovery proceedings should not fall foul of this provision. It is also a defence to show that the settlement

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Ensuring that the creditors are treated equitably

did not arise from any intention to prefer but was a response to commercial pressure, eg to avoid legal proceedings.

Care should be taken about any new money introduced to support the business in the short term. The preference provisions do not allow these funds to be repaid before other creditors. In these circumstances, care should be taken either to give the creditor a charge at the time the additional loan is obtained or to obtain a further loan from a creditor who already has a charge that would secure further advances.

Only a liquidator or an administrator can start an action, not a receiver or a supervisor of a voluntary arrangement.

The insolvency practitioner would be liable for costs if his action failed. He would not therefore take an action unless the preference was material and there was a reasonable prospect of success.

As with transactions at undervalue, a breach of this section is not a criminal issue and the court will impose the remedy of restoring the position to that before the preference. Similarly, preferences are also matters that the DTI take into account when considering disqualification. More blatant and deliberate preferences could be covered by criminal measures intended to prevent fraud.

Avoidance of floating charges – s 245 Insolvency Act 1986

A floating charge can be deemed to be invalid if given within a period before liquidation or administration, except to the extent that new money was introduced or services were provided at the time or subsequently.

The relevant period is

- Twelve months before the appointment where the company is unable to pay its debts either before or after the granting of the charge
- or, in the case of a connected creditor, in the two year period before the appointment.

Care needs to be taken as to whether a charge is in fact a floating charge. Purported fixed charges can be deemed to be floating because, for example, it is not possible to identify the assets in question, where the charge seeks to attach to all assets and where the chargee has insufficient control.

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Ensuring that the creditors are treated equitably

Transactions defrauding creditors – s423 Insolvency Act 1986 (as applied to companies)

When a company has entered into a transaction at an undervalue which the court is satisfied is intended to put assets beyond the reach of anyone making a claim against it, then it can order the transaction to be reversed and take steps to protect the interests of those who are victims of the transaction.

Such actions are normally taken by an insolvency office holder but can also be taken by an individual victim.

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Restrictions placed on individuals acting as directors in the future

Use of insolvent company's name – s 216/217 Insolvency Act 1986

A director of a company that enters into insolvent liquidation requires court approval within seven days to be a director of, or involved in the management of, another company with a name which is so similar as to suggest an association with the first company for a period of five years from its insolvency.

As an alternative, if the business of the current company is acquired from an insolvency office holder, then the directors can instead give notice to the creditors within 28 days of acquisition to explain that they are using a similar name.

The court's approval is not required where another non-dormant company has been known by the same name as a company in liquidation for at least twelve months beforehand.

If a person contravenes the above restrictions, then he is personally responsible for all the debts of the company that are incurred when he is involved in the management of the company.

A person is also personally responsible for all the debts of the company that are incurred when he acted on the instructions of someone else to help him contravene these restrictions.

The personal liability under these rules is joint and several with any other individual who has breached them.

Director disqualification – Company Directors Disqualification Act 1986

Any insolvency practitioner other than a supervisor of a voluntary arrangement has a duty to report to the DTI whether in his view the directors are not fit and proper people to be involved in the management of a company.

The DTI has two years from the start of the insolvency procedure in which to bring an action and the court decides whether to make an order to disqualify for between two to fifteen years. Alternatively the DTI can invite a director to give a voluntary disqualification undertaking, which has the same effect.

The matters which the DTI take into account are reckless management, trading to the detriment of creditors, failing to put the company into an insolvency procedure when it is clearly appropriate, excessive deficiency, fraud, failure to co-operate with an insolvency practitioner, poor accounting records, excessive Crown debt arrears,

Disqualifications have significantly increased in recent years. Even if an action is not successful, defending it can be costly and cause unwelcome distraction and stress.

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Requirement to cooperate with an insolvency office holder

Getting in the company's property – s234 Insolvency Act 1986

Where a company is in administration, administrative receivership or liquidation, then the court can require that any person forthwith passes to the office holder any property, books, papers or records to which the company appears to be entitled.

Where an office holder seizes or disposes of any property which is not property of the company but has reasonable grounds for believing he is entitled to do so, then he is not liable to any person in respect of any consequent loss or damage except to the extent it was caused by his negligence. He also has a lien on the property, or the proceeds of its sale, for the expenses that were incurred in connection with the seizure or disposal.

Duty to cooperate with office-holder – s235 Insolvency Act 1986

Where a company is in administration, administrative receivership or liquidation, then the office holder is able within reason to insist that any relevant people give him information concerning the company and its promotion, formation, business, dealings, affairs or property and attend on him at any reasonable time. The relevant people are

- Anyone who has been an officer of the company
- Has taken part in the formation of the company at any time within one year before insolvency
- A employee or former employee of the company
- An employee of an officer of the company
- Someone who acted previously as an insolvency office holder

If anyone fails without reasonable excuse to comply with these obligations, them he is liable to a fine.

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Requirement to cooperate with an insolvency office holder

Inquiry into company's dealings, etc. – s236 Insolvency Act 1986

Where a company is in administration, administrative receivership or liquidation, then the office holder can apply to the court summon before it

- Any officer of the company.
- Any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company.
- Any person whom the court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.

The court can require the above people to submit an affidavit to the court containing an account of his dealings with the company or to produce any company books, papers or other records in his possession or under his control.

Where a person without reasonable excuse fails to appear before the court when summoned or there are reasonable grounds for believing that a person has absconded, or is about to abscond, to avoid appearing, then the court can issue a warrant for the arrest of that person and the seizure of any books, papers, records, money or goods in that person's possession. The court can also order anyone arrested to be kept in custody until that person is brought before the court.

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