

Directors'
Duties when a
Company is
facing
Insolvency

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DIRECTORS' DUTIES WHEN A COMPANY IS FACING INSOLVENCY



Introduction

It is well established that the fiduciary and statutory duties of directors are generally owed to the company. However, where a company is insolvent or is threatened with insolvency this fundamental principal changes; the duty to act in good faith and to show the utmost care, skill and diligence will become owed by the directors to the creditors.

This does not mean that a company should close down at the first sight of economic difficulty. Although the directors may have no choice but to recommend placing the company in liquidation and distributing the assets for the benefit of the creditors, this may not always be the case. It may be that by trading forward, a more favourable outcome for creditors is achieved. Where it is reasonable to continue to trade, for example in an effort to complete a contract and generate further revenue, the directors will not necessarily be on the hook for reckless trading. This was recognized in *Re: Hefferon Kearns Limited (No. 2)*¹, where the Court commented that

“it would not be in the interests of the community that whenever there might be significant danger that a company was going to become insolvent, the directors should immediately cease trading and close down. Many businesses which might have well survived by continuing to trade coupled with remedial measures could be lost to the community”.

However, continuing to trade with caution in times of difficulty should be contrasted with not winding up a company which has been shown to be insolvent and the principal reason for not winding it up is that the assets would be insufficient to cover the associated costs. Section 251 of the Companies Act 1990 is intended to address this and identifies the remedies a liquidator or creditor may seek in such a situation. These include:

-  the power of the Court to impose criminal and civil liability on directors for failure to keep proper books of account;
-  the power to apply to Court for return of assets of the company improperly transferred;

¹ [1993] 3 IR 191

- ▣ liability for fraudulent and reckless trading; and
- ▣ restriction of directors.

Personal liability for debts of the Company

When considering how and where directors' duties are owed to creditors of a company, it is useful to recall those situations in which personal liability will be imposed.

Fraudulent Trading

If in the course of a winding up of a company, or where company has been shown to be insolvent but is not being wound up, or in the course of an examinership; any person found knowingly a party to the carrying on of the business of a company with intent to defraud its creditors or for any fraudulent purpose, may be guilty of fraudulent trading under Section 297 of the Companies Act 1963. Section 297 provides for a maximum penalty of imprisonment for a term not exceeding seven years or a fine not exceeding €63,487 or both. In addition, any such person may be personally responsible for all or any of the debts of the company as the Court may direct. Diverting monies payable to the company to a director or shareholder, incurring credit at a time when to the knowledge of the director there is no prospect of that credit being repayable, non-payment of monies to employees or to pension funds would all constitute fraudulent trading.

Just one instance of fraudulent behaviour may suffice to constitute fraudulent trading. In *Re Hunting Lodge Limited*², there was a secret arrangement to divert half of the proceeds of the sale of the only remaining company asset to a building society account with fictitious names. The company was insolvent at the time. This single transaction was enough to constitute fraudulent trading by the directors.

Reckless Trading

Reckless trading was introduced into Irish company law as a lesser offence to fraudulent trading to capture situations where there was no actual intent to defraud. If in the course of the winding up of a company or in the course of examinership proceedings or where an insolvent company is not being wound up, it is found that any officer of the company was knowingly a party to the carrying on of the business in a reckless manner, then pursuant to Section 297A of the Companies Act 1963, such person may be personally liable for all or any part of the debts or other liabilities of the company.

² [1985] ILRM 75

An officer of a company is knowingly a party to the carrying on of any business of the company in a reckless manner if:

- ▣ having regard to the general knowledge, skill and experience that might reasonably be expected of a person in that position he ought to have known that his actions or those of the company would cause loss to any creditor of the company, or
- ▣ he was a party to the contracting of new company debt and did not honestly believe on reasonable grounds that the company would be able to pay that/other debts when falling due.

The defendant director must have knowledge or imputed knowledge that his actions would cause loss to creditors; it is not sufficient that there was a concern or uncertainty about the ability to pay all creditors. It is a defence to show that a director has acted in an honest and responsible manner. However, failure to actively take part in the affairs of the company may not provide relief from liability since the failure to exercise proper control may amount to recklessness.

Failure to keep Proper Books of Account

Where a company is being wound up and is insolvent and it has failed to keep proper books of accounts in accordance with Section 202 of the Companies Act 1990, the Court may declare that any officer or former officer of the company who is in default of this obligation to keep proper books is personally liable for all or such part of the debts of the company as may be specified by the Court where the failure to keep books contributed to the insolvency. Case law shows that the Court will impose liability for such amount of the company's debts as are directly attributable to the failure to keep proper books. The Court may also find every officer of the company who is responsible for the failure guilty of an offence and a fine of up to €12,700 or imprisonment for a term not exceeding five years or both imprisonment and fine can be imposed.

Fraudulent Preference

Fraudulent preference is the wrongful favouring of one creditor over others by a company which is unable to pay its debts. Any such payment is invalid. Demonstrating preference is crucial and this can be difficult for a liquidator looking to challenge the payment; for example, the payment of a creditor who has simply been very diligent about pursuing a debt will not

amount to fraudulent preference.

Where a company is put into liquidation, any preference of a creditor in the prior six months may potentially be set aside as a fraudulent preference. Where the creditor is a director of the company or a person connected with a director, the liquidator can consider any payments made in the previous two years. Any repayments of debts owed to directors or shareholders by an insolvent company are likely to be scrutinised most closely by a liquidator.

A Voluntary Winding Up

On a voluntary solvent winding up of a company, the directors of a company must make a statutory declaration to the effect that the company will be able to pay its debts in full within twelve months from the commencement of the winding up. Where it is subsequently proved that the company is unable to pay its debts, the Court may, declare that any director who made the declaration of solvency is personally responsible for all or any of the company's debts.

Other Sanctions

Aside from personal liability, the following sanctions may also be imposed on directors of insolvent companies:

Restriction Order

If an insolvent company is wound up then, unless the Director of Corporate Enforcement (DCE) relieves the liquidator from doing so, the liquidator must apply to the High Court for an order restricting each of the directors of the company from acting as a director or secretary of company for five years (a "Section 150 Order"). The Court will make the order unless the director can satisfy the Court that he has acted honestly and responsibly in relation to the company and that there is no other reason making it just and equitable to make such an order against him. Although the Supreme Court has recently described this regime as "draconian"; and in the relevant case, lifted a restriction order that had been granted by the High Court³; the statutory provisions remain unchanged.

³ In the matter of Tralee Beef and Lamb Limited (in liq), Kavanagh v Delaney and Ors.

In *La Moselle Clothing Limited*⁴ the Court set out the factors to be considered in determining if a director has acted “responsibly”:

- ▣ the extent to which the director has or has not complied with any obligation imposed on him by the Companies Acts 1963 – 2006;
- ▣ the extent to which his conduct could be regarded as so incompetent as to amount to responsibility;
- ▣ the extent of the director’s responsibility for the insolvency of the company;
- ▣ the extent of the director’s responsibility for the net deficiency in the assets of the company disclosed at the date of the winding up or thereafter; and,
- ▣ the extent to which the director in his conduct of the affairs of the company has displayed a lack of commercial probity or want of proper standards.

Section 150 of the Companies Act 1990 applies to any person who was a director of the insolvent company in question either at the date of or within 12 months prior to the commencement of its winding up. The section also applies to shadow directors. Shadow directors are persons in accordance with whose directions or instructions the directors of a company are accustomed to act. Case law indicates that one single act or omission can result in a restriction order being imposed.

A restricted director cannot be a director of a company in the future unless that company is capitalized to just under €63,500 if a private company and to just under €317,500 if a plc. Although in the case of a private company in particular this level is not unduly high, the Supreme Court has acknowledged the “grave stigma” a restriction order presents for the individual concerned.

In a recent case (*Worldport Ireland Limited*, 16 December 2008), the Irish Supreme Court held that that bodies corporate or companies cannot be restricted under Section 150, notwithstanding that a company may still fall within the definition of “shadow directors”.

Disqualification Order

Section 160(1) of the Companies Act 1990 provides for automatic disqualification for a

⁴ (1998) 2 ILRM 401

period of five years or such other period as the Court may order, from acting as an auditor, director, other officer, receiver, liquidator or examiner, where a person, (i.e., not necessarily a director) is convicted on indictment of any indictable offence in relation to a company or involving fraud or dishonesty. Unlike a restriction order, the onus is on the liquidator or other applicant to show that the director's conduct justifies a disqualification order.

In addition to the various provisions discussed above, which relate directly to insolvent companies, there are provisions where personal liability may arise under other statutory provisions if the relevant actions contributed to the insolvency of a company or were carried out when the company was not solvent. Loans to directors and matters relating to financial assistance should all be approached with even more caution during economic difficulty.

Conclusion

Case law demonstrates that the Courts are mindful that directors have to operate in difficult situations and that it is not always in the best interests of a company, its creditors or the community at large to immediately cease trading when there is possibility that the company could become insolvent.

Directors, nonetheless, need to be especially careful and diligent in conducting the affairs of a company where it is either already technically insolvent or facing the possibility of insolvency. Directors need to be cognizant of the personal liabilities that can arise when a company is insolvent and that their conduct vis-à-vis new or existing creditors, the creation or discharge of any company debt as well as the use and/or transfer of any of the assets of the company takes on an increased importance.

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