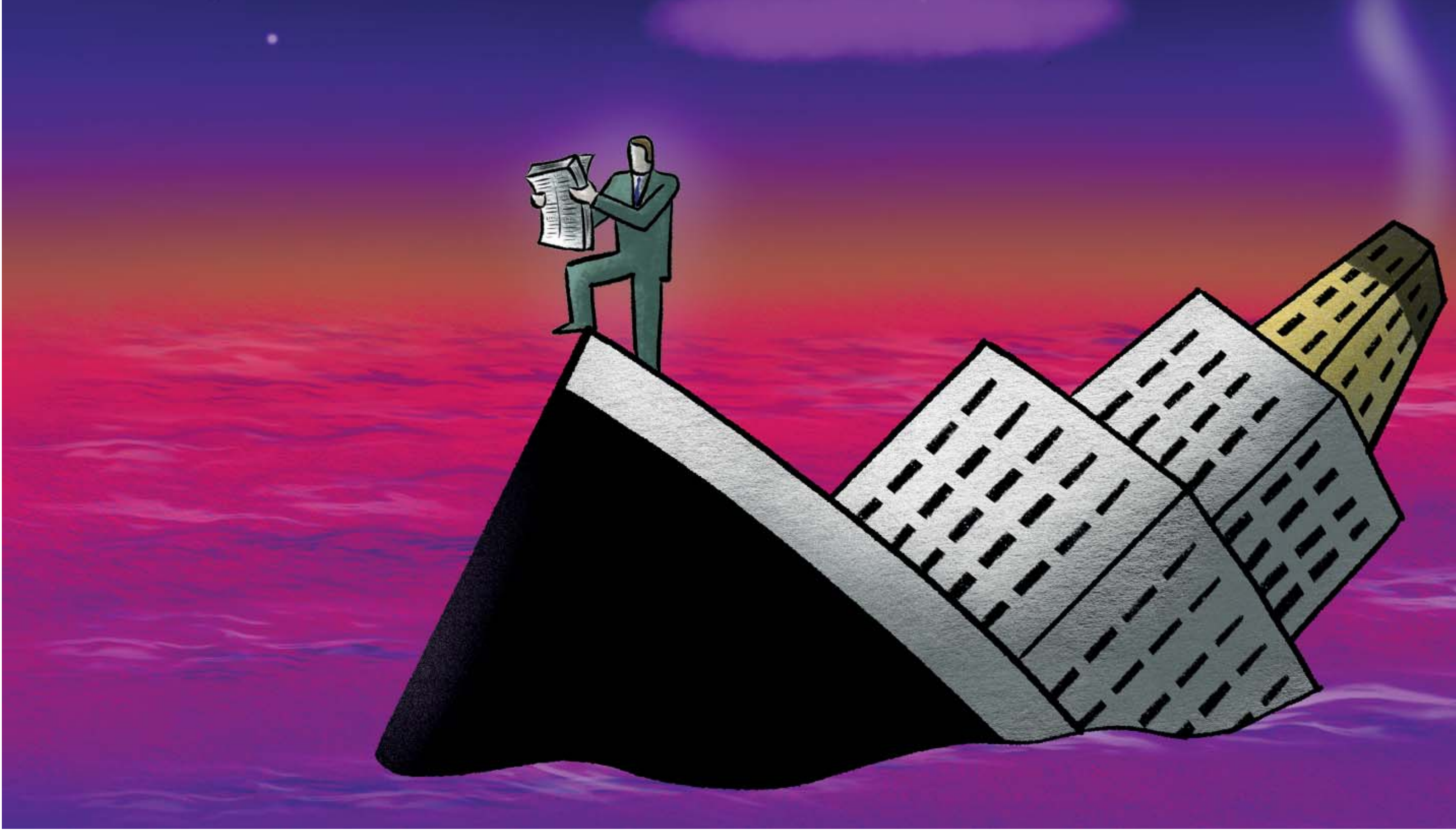

DIRECTORS' DUTIES ON INSOLVENCY
NAVIGATING THE TWILIGHT ZONE

David Ereira of Paul Hastings LLP discusses directors' duties and liabilities in the period leading up to and on insolvency.

At a time when the actions of directors, both collectively and individually, have received considerable attention in both the academic and public press, the need for directors to understand their duties, and the steps that can be taken to fulfil their obligations and minimise potential liabilities, becomes especially important.

This article considers:

- The duties imposed on directors of private and public limited companies by law and equity.
- How these duties change and affect directors' decision-making processes in the moments leading up to insolvency, known as the "twilight zone", and on insolvency.
- The potential liabilities that directors face.

This article does not expressly consider the duties and liabilities associated with trustees, and other corporate forms, although there is, in certain instances, a degree of convergence.

WHO IS A DIRECTOR?

The term "director" would appear, at first glance, to be relatively straightforward to define. However, the meaning of "director" can vary depending on the context in which it is being discussed.

The starting point is the Companies Act 2006 (2006 Act), which defines a director as "any person occupying the position of a director, by whatever name called" (*section 250*). This definition mirrors that used in section 251 of the Insolvency Act 1986 (1986 Act). This would clearly include a person appointed in accordance with the relevant company's articles of association (a de jure director), but would also include a person not appointed as a director who nevertheless acts as, and assumes the responsibilities of, a director (a de facto director).

Exactly who can be said to be a de facto director will be fact-specific but the Supreme Court has held that the question is whether he was part of the corporate governance system of the company and whether he assumed the status and function of a director so as to make himself responsible as if he were a director (*Smithton Ltd v Naggar [2014] EWCA Civ 939*).

In addition to de jure and de facto directors, section 251 of the 2006 Act provides the further category of a shadow director. In relation to a company, this covers a person in accordance with whose directions or instructions the directors of the company are accustomed to act. It does not have to be proved that all directors act in accordance with the directions of the shadow director; it is enough that a majority do so (*McKillen v*

Misland (Cyprus) Investments Limited [2012] EWHC 521 (Ch)). The 2006 Act definition excludes a company's parent company from the definition of shadow director, whereas the 1986 Act definition does not.

In practice, the question of who is a de facto or shadow director is a mixed question of fact and law, and the label attached to the office or employment of a person is seldom conclusive.

Despite the functional difference between the two, insolvency law does not formally recognise the distinction between the duties of executive and non-executive directors. The distinction may, however, become relevant in assessing the degree of knowledge, skill and experience that is to be expected of a non-executive director. This issue can come to the fore when analysing directors' liabilities as a company approaches, and eventually enters into, insolvency.

Indemnification and insurance

Section 233 of the Companies Act 2006 (2006 Act) provides that provisions attempting to exclude a director from his liabilities in respect of the company are void. However, under section 234 of the 2006 Act, a company can indemnify its directors and buy directors' liability insurance for the benefit of its directors.

Directors of all companies should always ensure that they check, and where necessary modify and renew, the terms of any indemnification from the company. Directors should be mindful of the fact that any indemnity provided by the company is only as strong as what the company is able to provide. In an insolvency scenario, these indemnities are unlikely to be of much use.

Claims against directors are very often costly exercises and, if proven, can lead to sanctions other than damages, such as fines, disqualification and imprisonment. Directors and officers (D&O) insurance policies provide cover for current and former directors, and usually provide cover for the costs of defending the types of claims covered in this article (*see feature article "D&O insurance: diving for cover", www.practicallaw.com/5-521-6870*). However, there is no obligation on a company to provide its directors with D&O insurance and, indeed, in many cases directors will not even know that they are covered, less still of the extent of the coverage. Although it becomes particularly relevant as a company approaches insolvency, directors should acquaint themselves with the terms of their policies. Retiring directors should also seek assurances that they remain covered for a certain period after leaving office.

DIRECTORS' DUTIES AND LIABILITIES

There are no formal qualifications required to become a director. In spite of this, on appointment as director, and in some cases following resignation, there are many duties that arise, and liabilities that potentially flow, from acts taken in that position (*see box "Indemnification and insurance"*).

General duties

Historically, directors have owed fiduciary duties to their companies. While there is no comprehensive legal definition of a fiduciary, the classic definition comes from the Court of Appeal in *Bristol & West Building Society v Mothew*, which described a fiduciary as someone who has undertaken to act for, or on behalf of, another in a particular matter in circumstances which give rise to a relationship of trust and confidence (*[1996] EWCA Civ 533; www.practicallaw.com/3-100-2365*). The court said that the distinguishing feature is the obligation of loyalty: the principal is entitled to the single-minded loyalty of his fiduciary.

Chapter 2 of Part 10 of the 2006 Act codifies most, but not all, of the duties imposed by case law and equitable principles on directors of companies. There are seven general duties codified in sections 170 to 177 of the 2006 Act. These duties are owed to the company and, in general, only the company can enforce them (*section 170(1), 2006 Act*). However, section 260(3) of the 2006 Act provides shareholders with the ability to bring an action in respect of a cause of action vested in the company from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust.

Of the seven general duties, three are particularly relevant to companies in financial difficulties:

- The duty to promote the success of the company for the benefit of its members as a whole (*section 172, 2006 Act*).
- The duty to exercise independent judgment (*section 173, 2006 Act*).
- The duty to exercise reasonable care, skill and diligence (*section 174, 2006 Act*).

Directors' duties apply from the moment of appointment and, with a few exceptions, cease to apply following a director's resignation; for example, the duty to avoid conflicts of interest will continue to apply as regards the exploitation of property, information or opportunity of which a director became aware at the time they were a director (*section 170(2), 2006 Act*). In addition, a director will continue to owe duties of confidence to the company following resignation. Where more than one duty applies in any given scenario, the directors must comply with each duty (*section 179, 2006 Act*).

The duty incumbent on directors to promote the success of the company for the benefit of its members as a whole has received a considerable amount of comment and debate in the courts and among the academic community. The Court of Appeal has described this duty as the fundamental duty to which a director is subject and from which the other fiduciary duties of a director flow (*Item Software (UK) v Fassihi [2004] EWCA Civ 1244; www.practicallaw.com/4-102-7600*).

For present purposes, what is particularly relevant is that this duty applies to all decisions made by a director, not only those formal decisions approved by the board. In addition, when the company is solvent, directors owe their duties toward the company, with shareholder primacy dominating managerial considerations. However, the duty is subject to any enactment or rule of law requiring directors in certain circumstances to consider or act in the interests of the creditors of the company (*section 172(3), 2006 Act*).

In addition, while the 2006 Act statutory duties must be interpreted and applied in the same way as the equitable principles, and in many respects merely restate the prior fiduciary and common law duties, there are instances where they introduce new concepts and rules. For example, the fiduciary duties of a shadow director are now more extensive and, although they cannot be equated with those of an ordinary director, they can be said to extend to the directions or instructions given by the shadow director to the majority of the board (*Vivendi SA v Richards [2013] EWHC 3006*).

In addition to the duties codified by the 2006 Act, directors should also be aware of their role as fiduciaries in the context of their relationship as custodian of the company's assets.

The twilight zone and insolvency

The discussion of directors' general duties is of importance in an insolvency proceeding, such as a liquidation or administration, because of the ability of the relevant insolvency practitioner to take action against an offending director in the pursuit of a greater recovery for the company's creditors. But how and when exactly those general directors' duties are affected by a company's financial difficulties and on insolvency is a difficult question to answer.

It is widely accepted that the duties owed by a director to a company are altered in insolvency, or its vicinity, so as to require directors to have proper regard for the interests of creditors (*West Mercia Safetywear v Dodd (1988) 4 BCC 30; Jetivia SA v Bilta (UK) Limited (in liquidation) [2015] UKSC 23, see News brief "Clarifying the illegality defence: no end to the carousel?", www.practicallaw.com/9-614-4192*). While it is clear that this rule comes in to play before the start of a formal insolvency process, precisely when it becomes relevant is less clear.

There is also much debate on whether the effect of the duty shift requires exclusive focus on the interests of creditors, as in *Miller v Bain and others*, or requires creditors' interests to be treated as paramount, as in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* (*[2002] 1 BCLC 266, www.practicallaw.com/9-101-6741; [2003] BCC 885, www.practicallaw.com/1-102-2675*).

A further area of ambiguity arises as regards the meaning of creditors' interests, given that creditors are unlikely to comprise an homogenous group and that in an insolvency scenario, certain creditors are likely to be out of the money. It appears that it is the interests of creditors as a whole or as a class that should be considered (*Re Micra Contracts Ltd (in liquidation) [2016] BCC 153; Capital for Enterprise Fund A LP and another v Bibby Financial Services Ltd [2015] EWHC 2593 (Ch)*). However, it also remains unclear how directors should proceed when there would likely be disagreements on the deployment of company assets within the creditor group.

Duties of co-operation, investigation and examination

The Insolvency Act 1986 (1986 Act) vests a number of powers in the officeholder (that is, the liquidator, administrator or administrative receiver) and the Official Receiver to assist with their investigation of directors' conduct. These include:

- Getting in the company's property. Section 235 of the 1986 Act (section 235) permits an officeholder to invoke the assistance of the court to get the company's property and records. It applies to any person who has in his possession or control any books, papers or records to which the company is entitled.

- The duty to co-operate with the officeholder. Section 235 imposes this duty on any person who is at the moment of winding up, or ever has been, a director of the company and requires directors to provide the officeholder with any information that he may, in his absolute discretion, reasonably require. Information provided can be used by the Secretary of State in determining whether director disqualification proceedings should be brought.

- Enquiry into the company's dealings. Section 236 of the 1986 Act (section 236) vests in the officeholder a private examination power, which applies to current directors but also more broadly and includes any person known or suspected to have in his possession any property of the company, or any person who is supposed to be indebted to the company.

What is striking about these provisions is the ability of the court, exercising its discretionary powers, to compel a wide range of individuals (including directors, past and present) to assist it in investigating the circumstances surrounding a company's demise.

Public examination

In the current environment, it is also worth noting the powers of the Official Receiver when a company is being wound up to apply to court for public examination of any person who is, or was, a director of a company (*section 133, 1986 Act*). This power is designed to complement the private examination power under section 236.

Pensions Regulator

In addition to those duties of co-operation, investigation and examination owed to the officeholder, directors of companies with pension schemes should also have regard to the obligations that they owe to the Pensions Regulator. Following the collapse of BHS, former owner Dominic Chappell was prosecuted in connection with his failure to provide information and documents on three occasions, without reasonable excuse, when required to do so under section 72 of the Pensions Act 2004 (2004 Act), contrary to section 77(1) of the 2004 Act. The failure to provide such information can result in an unlimited fine. Additionally, those involved can suffer serious reputational damage from being convicted of non-compliance with the law.

POTENTIAL LIABILITIES

Directors of all companies should at all times be mindful of the provisions of the 2006 Act and 1986 Act under which they may face potential liability as a consequence of actions taken in office during the period before and on insolvency (*see box "Duties of co-operation, investigation and examination"*).

Wrongful trading

The most notorious of the civil liabilities potentially faced by directors of an insolvent company under the 1986 Act is wrongful trading, which was introduced in response to the ease with which directors could walk away from a company they had mismanaged, free from personal liability (*sections 241 and 246ZB*).

Potential defendants. A wrongful trading claim may be brought against a de jure, de facto or shadow director. Section 214(1) of the 1986 Act refers to a person who is or has been a director of the company, and section 214(7) of the 1986 Act expressly includes shadow directors within the scope of this provision.

Potential claimants. A claim for wrongful trading can be brought by either a liquidator in an insolvent liquidation or an administrator in an insolvent administration, and is exercisable with sanction from the company's creditors or the court.

Acts amounting to wrongful trading. To successfully prove a wrongful trading claim, the liquidator or administrator must show that at some point before the start of formal insolvency proceedings, the relevant director knew, or ought to have known, that there was no reasonable prospect of avoiding an insolvent liquidation or insolvent administration (the point of no return) and that the director failed to take every step with a view to minimising potential further losses to creditors (*section 214(2), 1986 Act*) (section 214(2)).

Section 214(2) is drafted widely, ensuring that a wide variety of acts and omissions are capable of being caught, not just trading activities. Examples of evidence that may be supportive of a finding that the directors ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation or insolvent administration include:

- Company accounts showing liabilities exceeding assets.
- Proceedings are brought against the company for unpaid sums.
- Failure to meet sales or cash flow targets or forecasts.
- Other evidence of increasing creditor pressure, for example, the bank calling in or refusing to extend the company overdraft, or suppliers refusing to make further deliveries until outstanding invoices are settled.

In determining whether section 214(2) has been made out, the court will apply the reasonably diligent person test. Under this test, the facts that a director ought to have known or ascertained, the conclusions that he ought to have reached and the steps that he ought to have taken, are those which would have been known or ascertained, or reached or taken, by a reasonably diligent person having both:

- The general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the relevant director (the objective test).
- The actual knowledge, skill and experience of that particular director (the subjective test).

The court will apply the higher of the two standards.

For example, although under the objective test, less may reasonably be expected of a director of a small company with less sophisticated financial systems than a much larger company, there is an objective minimum standard below which no director may fall. The court will, however, also look at the subjective test, and may apply a higher standard if, for example, the director in question has considerable relevant experience or a relevant professional qualification, such as an accountant.

Sanction. The court has wide discretion to determine the extent of a director's liability, which is usually in the form of a contribution order. Case law suggests that the contribution will ordinarily be based on the additional depletion of the company's assets caused by the director's conduct from the date that the director ought to have concluded that the company could not have avoided insolvency liquidation or administration. An order to contribute may be made against directors on a joint and several basis. However, the court has wide discretion to apportion liability between directors based on their respective culpability by ordering the more culpable

Company Directors Disqualification Act 1986

The Company Directors Disqualification Act 1986 (CDDA) provides that, on application of the Secretary of State, a disqualification order may be made by the court against a de jure, de facto or shadow director of a company that becomes insolvent, if his behaviour makes him unfit to be involved in the management of a company. In this sense, as noted by the Insolvency Service guidance on director disqualification, the CDDA seeks to maintain the integrity of the business environment by ensuring that those who become directors of limited companies comply with all laws and relevant regulations, act honestly and responsibly, and exercise skill and care with proper regard to the interests of the company's creditors, customers, shareholders, employees and, in some circumstances, the general public (*www.gov.uk/government/uploads/system/uploads/attachment_data/file/657922/CDDA-and-failed-companies-november-2017.pdf*).

The CDDA supplements the claims available under the Insolvency Act 1986 and provides an additional basis by which to sanction directors. For example, the wide discretion afforded to the court when making a contribution order on a finding of wrongful or fraudulent trading extends to the making of a disqualification order under section 4 and 10 of the CDDA (as applicable). In addition, a finding of misfeasance is a relevant factor to which a court will have regard when considering whether to make a disqualification order against a director for unfitness under section 6 of the CDDA.

Following conviction under section 209 of the Insolvency Act 1986, the court has the power to make a disqualification order against the director under section 2 of the CDDA. This can result in a period of disqualification of 15 years on indictment, or five years in the magistrates' court.

directors to indemnify the less culpable directors.

Where the court makes a contribution order against a director under this section, the court has a discretion to also make a disqualification order against that director under the Company Directors Disqualification Act 1986 (*see box "Company Directors Disqualification Act 1986"*).

Defence. Directors might be able to escape liability if they can satisfy the court that after they first knew or ought to have concluded that there was no reasonable prospect of avoiding an insolvent liquidation or administration, they took every step with a view to minimising the potential losses to creditors (the every step defence) (*section 214(3), 1986 Act*).

In addition, in seeking to absolve himself from liability, a director will likely also seek to invoke section 1157 of the 2006 Act. This statutory defence is routinely pleaded as a last line of defence and provides the court with the discretion to grant relief in proceedings for negligence, default, breach of duty or breach of trust where the court is satisfied that the director acted honestly and reasonably, and when taking all the circumstances of the case together, he ought fairly to be excused.

The distinction between executive and non-executive directors as regards the degree of knowledge, skill and experience that might be expected of them may also be relevant when assessing potential liability. However, as noted in the House of Commons report on BHS that was published on 25 July 2016, non-executive directors are not entitled to place unquestioning reliance on others to do their job, and the chairman of the board will be responsible to a greater extent than others for the performance of the board as a whole and each member of it (*https://publications.parliament.uk/pa/cm201617/cmselect/cmworpen/54/54.pdf*).

Resignation is generally not looked on favourably and is commonly regarded as an abrogation of a director's responsibilities. However, if an individual director makes unsuccessful repeated attempts to get the board to listen to his views, resignation may be the only option.

Time limit. Wrongful trading claims come within the scope of section 9(1) of the Limitation Act 1980, which provides for a limitation period of six years, starting on the date that the company went into insolvent liquidation or administration.

Fraudulent trading

The civil liability imposed by section 213 of the 1986 Act (section 213) for fraudulent trading seeks to cover the situation where a company suffers loss that is caused by the carrying on of the company's business with intent to defraud.

Potential defendants. A fraudulent trading claim may be brought against a de jure, de facto or shadow director or against any person who is knowingly party to the carrying on of any business of the company with intent to defraud creditors or for any fraudulent purpose (*section 213(3), 1986 Act*). This is in contrast with wrongful trading, where this intent does not have to be shown.

Potential claimants. A claim for fraudulent trading can be brought by either a liquidator in an insolvent liquidation or an administrator in an insolvent administration, and is exercisable with sanction from the company's creditors or the court (*sections 213(2) and 246ZA, 1986 Act*).

However, the recent changes to the 1986 Act brought about by the Small Business, Enterprise and Employment Act 2015 now make it possible for a liquidator or administrator to assign the right to bring wrongful or fraudulent trading proceedings. Given the challenges faced by insolvency practitioners in bringing these claims, especially in terms of cost, these changes could lead to the increased involvement of large creditors pursuing these actions.

Acts amounting to fraudulent trading. Actual dishonesty must be proved. The courts have interpreted the terms "defraud" and "fraudulent purpose" to require actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame (*Re Patrick and Lyon Ltd [1933] Ch 786*). In further contrast to wrongful trading, dishonesty is assessed only on a subjective basis; in other words, what the particular person knew or believed.

Sanction. A director found liable for fraudulent trading can be ordered to make such contribution to the company's assets as the court thinks fit. There is no power to include a punitive element in the amount of this contribution, which should reflect and compensate for the loss that has been caused to the creditors by the fraudulent trading (*Morphitis v Bernasconi and others [2003] EWCA Civ 289; www.practicallaw.com/9-102-3181*).

Where the court makes an order against a person under section 213, it has a discretion to also make a disqualification order against that director (*see box "Company Directors Disqualification Act 1986"*).

In addition, criminal sanctions can be imposed by the court under section 993 of the 2006 Act to punish a person knowingly party to fraudulent trading, whether or not the company is being wound up. The penalties are imprisonment of up to ten years on indictment or a fine, or both.

Defence. As section 213 is determined subjectively, if a director genuinely believed on a subjective basis, however unrealistically, that things would get better and the company would trade out of its difficulties, this would provide an effective defence.

Time limit. Fraudulent trading claims come within the scope of section 9(1) of the Limitation Act 1980, which provides for a limitation period of six years, starting on the date that the company went into insolvent liquidation or administration.

Misfeasance

Section 212 of the 1986 Act (section 212) codifies the common law principle that a company can claim against its directors for breach of fiduciary duty, and provides a summary procedure that is available in liquidation for the enforcement of rights. Section 212 does not create new liabilities but provides a simpler procedure for the recovery of property or compensation on a winding up. Most claims against directors are therefore brought under this section due to the fact that misfeasance is broadly defined and, therefore, easier to prove than other available rights of action, in addition to being less costly to pursue.

Potential defendants. Section 212 applies to current and former de jure and de facto directors (*Holland v Revenue and Customs; Re Paycheck Services 3 Ltd [2010] UKSC 51*). However, it appears not to apply to shadow directors since other provisions of the 1986 Act specifically state that shadow directors are included and section 212 does not.

Potential claimants. An application for misfeasance can be made by a liquidator, Official Receiver or any creditor or contributory (*section 212(3)*). It is usually the liquidator that makes the application to court rather than a creditor. If a creditor wishes to make an application, they should notify the liquidator so that the liquidator can consider making its own application, in order to avoid concurrent proceedings.

Acts amounting to misfeasance. Misfeasance covers the whole spectrum of directors' duties and therefore includes:

- Misapplication of any money or assets of the company.

- Breach of statutory duty, such as: unlawful loans to a director; a director entering into a contract with his own company and failing to notify the board in contravention of section 177 of the 2006 Act; and a director failing to act within his powers.

- Breach of the duty of skill and care.

Directors responsible for transactions at an undervalue within the meaning of section 238 of the 1986 Act or preferences within the meaning of section 239 of the 1986 Act may thereby commit a misfeasance.

Sanction. Relief granted under section 212 will usually be compensatory, limited to the amount of actual loss and determined on the normal causation basis. These amounts are granted for the benefit of the company's creditors as a whole, rather than at the individual creditor level. A finding of misfeasance is also a factor to which the court will have regard when considering whether to make a disqualification order against a director for unfitness under section 6 of the Company Directors Disqualification Act 1986.

Defence. In common with wrongful trading claims, when deciding whether to make an order under section 212, the court can consider whether to allow the relevant director to rely on the statutory defence set out in section 1157 of the 2006 Act.

Time limit. The limitation period for a claim under section 212 is, in the vast majority of cases, six years, beginning on the date that the misfeasance or alleged breach of duty occurred.

Other fraud and misconduct offences

By way of brief overview, directors should be aware that a number of other offences apply to the conduct of directors on a winding up of a company. These include:

- Fraud in anticipation of a winding up under section 206 of the 1986 Act (section 206). Section 206(2) makes it an offence for a director to conceal or remove property, falsify entries in the company's books or perpetrate other similar acts after the commencement of a winding up. A director will be deemed to have committed this offence if found guilty of these acts in the 12-month period before a winding up.

- Transactions in fraud of creditors under section 207 of the 1986 Act. This provision makes it an offence for a director to make or have caused to be made any gift or transfer, or charge on, or to have concealed or removed any part of, the company's property. Intent to defraud is required and the relevant act must have been committed within five years of the date of the commencement of the winding up.

- Misconduct in the course of winding up under section 208 of the 1986 Act. This provision makes it an offence for a director to fraudulently or intentionally fail to disclose to the liquidator all the company's properties and related dealings with them, including all books and papers in his control belonging to the company which he is required by law to deliver.

- Falsification of the company's books under section 209 of the 1986 Act. This provision makes it an offence for a director to destroy, alter, falsify any books or papers (including computer records under section 436 of the 1986 Act) of the company, or to be privy to these acts, with an intent to defraud on a winding up of a company.

- Material omissions from statements relating to the company's affairs under section 210 of the 1986 Act.

- False representations to creditors under section 211 of the 1986 Act. This provision makes it an offence for a director to make any false representation or any other fraud for the purposes of obtaining the consent of any of the company's creditors to an agreement with reference to the company's affairs or to the winding up (whether by the court or voluntarily).

A director guilty of any of the offences under sections 206 to 211 is liable to imprisonment or a fine, or both.

Personal guarantees

It is not uncommon, especially in small, family-held private limited companies, for directors to provide a guarantee in respect of some or all of the company's liabilities. This can result in an individual director becoming liable for the company's debts. To avoid hidden surprises down the line, independent legal advice should be taken at the outset if a lender requires a personal guarantee from a director, particularly where the counterparty is a large, sophisticated, institutional lender.

DIRECTORS OF PUBLIC COMPANIES

In addition to the foregoing, directors of public limited companies whose shares are admitted to trading on either a regulated market, such as the Main Market of the London Stock Exchange, or a prescribed market, such as AIM, should also be aware of, and comply with, the obligations imposed by the following statutes and regulations:

- The Listing Rules, the Prospectus Rules and the Disclosure Guidance and Transparency Rules.

- The AIM Rules.

- The Financial Services and Markets Act 2000 (FSMA).

- The Financial Services Act 2002.

These statutes and regulations contain provisions detailing additional obligations on directors to disclose, for example, the details of their past experience and expertise (including any previous insolvency processes with which they have been associated in the past five years from the date of publication of a prospectus), and other provisions relating to the suspension of listing or trading.

Misleading statements and impressions

Under the Market Abuse Regulation (*EU 586/2014*), a company must inform the public as soon as possible of any inside information that directly concerns the company (*for background, see feature article "Market Abuse Regulation: ensuring compliance and* *uncertainty", www.practicallaw.com/6-629-5677*). This creates a tension for the directors of a company in financial difficulties and requires a balancing act of the adverse consequences of an uncertain and possibly premature disclosure against the duty to maintain market integrity. There are exceptions that permit delayed disclosure to protect the company's legitimate interests. Failure to disclose information in a timely manner may, however, lead to suspension of the company's shares, which might exacerbate the company's difficulties.

Market abuse

Directors must also ensure that their behaviour, including in deciding whether to make an announcement to the market and potentially creating a false market in securities, does not result in them committing the civil offence of market abuse under section 118 of FSMA. There are also criminal sanctions for a failure to make an announcement under section 397 of FSMA.

Serious loss of capital

Directors of public companies also have a duty to convene a meeting of shareholders in certain circumstances if there is a serious loss of capital (*section 656, 2006 Act*). A breach of these requirements can lead to the directors being liable to a fine.

PRACTICAL STEPS

As soon as directors become aware that a company is in financial difficulty, they should seek financial and legal advice, both collectively as a board, and on an individual level by seeking independent advice. It is at this juncture, which can be difficult to determine in the period before insolvency (*see "The twilight zone and insolvency" above*), that the actions of directors, past and present, fall sharply into view and when these persons are at their most vulnerable.

However, identifying the precise moment at which the financial position of a company means that insolvent liquidation or insolvent administration is inevitable can be very difficult and will likely turn on the facts of each case. Indeed, the courts have recognised that the answer to the question of when the point of no return arises does not depend on a snapshot of the company's financial position at any time; rather, it depends on the rational expectations of what the future might hold (*Re Hawkes Hill Publishing Co Ltd (in liquidation) [2007] EWHC 3073 (Ch)*).

It should also be noted that the courts recognise that they are viewing the circumstances surrounding company distress or failure with the benefit of hindsight and that an insolvent liquidation or administration will almost always result from one or more mistakes. This attitude has been reflected in a number of wrongful trading judgments but can also be of general application (*Re Hawkes Hill*).

Directors can take a number of practical steps to discharge their duties and minimise liability. At all times, directors must be capable of reasoning through their actions and forming rational expectations of what the future might hold, avoiding "confusion between aspiration and actuality" and being mindful not to indulge in "wilfully blind optimism" (*Re Onslow Ditchling Limited [2011] EWHC 257 (Ch)*).

Practically, and having engaged and consulted with appropriate advisers, when a director senses the point of no return is near or indeed upon the company, they should consider (among other things) the following with a view to establishing the every-step defence and the discharge of their duties generally:

- Hold regular board meetings to discuss the company's financial position and record accurate minutes of the discussions. Individual directors should ensure that best practice is followed and not hesitate to raise concerns. The minutes should address consideration of the interests of all stakeholders and provide a complete record of discussions, including those conducted before and after the meeting.

- Engage with lenders and other key stakeholders to ensure that there are no breaches of key financial covenants and, where there are, that prompt action is taken. In the case of public companies, this can involve the requirement to update the market.

- Continue to maintain good lines of communication with creditors, suppliers and stakeholders.

- Monitor demands for payment, and legal proceedings that are threatened or commenced against the company.

- Ensure that they have access to up-to-date financial information at all times.

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Recent case law reaffirms the fact that conscientious directors who act rationally, on an informed basis and in good faith are unlikely to suffer personal liability simply because a company becomes insolvent (*Re Hawkes Hill; Re Onslow Ditchling; and In the matter of Langreen Ltd (in liquidation) LTL 26/10/2011*). It is not necessary that every step the directors took with a view to minimising losses to creditors necessarily worked, but that the relevant directors acted rationally, drawing on their individual and collective skill and knowledge, and that of their legal and financial advisers.

The extent to which a director can rely on the professional advice he receives from his advisers is unclear. The additional questions that might be asked by the director when considering the professional advice question are:

- What is within my sphere of competence and expertise?

- What, acting reasonably, can I rely on in respect of what information?

Perhaps the more specialised the advice, the more a director will be entitled to rely on it, provided that the relevant professional is of good-standing and repute, and is suitably qualified. This is the approach taken by The Pensions Regulator in its guidance note for trustees issued in December 2007 (*www.thepensionsregulator.gov.uk/guidance/guidance-for-trustees.aspx*).

In other words, good faith reliance on the advice received from a financial or legal adviser reasonably believed to be a competent expert and selected with reasonable care should work to minimise potential liability. This reliance could inform the director's decision making when faced with events that might signal financial difficulties, such as an increase in short-selling of company stocks, or an unsolicited approach from a creditor or non-mandated financial adviser informing him of impending collapse.

Directors should also ensure that they co-operate, and are seen to be co-operating in a timely and reasonable manner, with any requests, for example for information, made by the relevant insolvency practitioner as he conducts his investigation into the circumstances surrounding a company's demise.

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