

Set out below is a summary of the principal considerations to be borne in mind by a director of the Company, in where there is underperformance ,distress or crisis in the financial positionof the Company.

This note addresses issues which should be considered by the directors of the Company both individually and collectively in pursuing a strategy designed to avoid a formal insolvency procedure.

It is important for directors to clearly understand the responsibilities that they have and the consequences of not acting, or not being seen to act, in the best interests of the Company's creditors.

THE DIRECTORS' DUTIES

In very general terms, the directors owe duties to the Company:

- To promote the success of the company
- When the Company is clearly solvent, each director of the Company must act in the way he considers, in good faith, would be most likely to promote the success of the Company for the benefit of its members as a whole and in doing so have regard (amongst other matters) to:
 - the likely consequences of any decision in the long term;
 - the interests of the company's employees;
 - the need to foster the company's business relationships with suppliers, customers and others;
 - the impact of the company's operation on the community and the environment;
 - the desirability of the company maintaining a reputation for high standards of

business conduct; and

- the need to act fairly as between the members of the company.
- However, where the Company is insolvent, or possibly even when it is of doubtful solvency, the directors are under a duty to consider the interests of creditors above the interests of members. One consequence of this is that the directors cannot assume that shareholder ratification or sanction for actions damaging the interests of creditors will relieve them of liability.
- To exercise independent judgment
 - Each director must make up his own mind on every decision he is required to take and should not allow himself to be influenced by his own interests or the interests of others. His duty is to act in the interests of the Company.
- To avoid conflicts of interest
 - There are several distinct duties that can be viewed as dealing with conflicts of interest. The overall principle of these duties is to ensure that each director separates his own interests (as shareholder, executive, creditor, etc) from the Company's interests and does not allow those interests to come into conflict or affect his judgment.
 - The principle duty is that each director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts or possibly may conflict with the interests of the Company. It may be possible for the other directors to authorise a conflict, however, they need the power to do so and they must consider their own duties in giving such authorisation.
- To take steps to avoid loss to creditors
 - Under section 214 of the Insolvency Act 1986, personal liability for wrongful trading may arise for directors of a company which has gone into insolvent liquidation. Liability for wrongful trading is established if, on an application to court by a liquidator, it can be shown that at some time before the company went

into insolvent liquidation, the director knew or ought to have concluded there was no reasonable prospect that the company would avoid insolvent liquidation, unless it can be shown that the director thereafter took every step he ought to have taken with a view to minimising the potential loss to the company's creditors. This potential liability for wrongful trading is explained in more detail below.

- The directors should never allow the Company to accept credit if in their view there is no reasonable expectation of the creditor being paid, since this would involve them in the criminal offence of fraudulent trading
- Not to enter transactions at an undervalue or make preferences
 - Under sections 238 and 239 of the Insolvency Act 1986, the administrator or liquidator of a company may apply to the court to set aside or vary transactions at an undervalue and preferences entered into within a specified period before the commencement of the insolvency proceeding. Transactions at an undervalue and preferences cannot be set aside unless the company was insolvent at the relevant time or became insolvent as a result of the transaction. In formulating a strategy to avoid a formal insolvency procedure, the directors need to be aware of these provisions since, if transactions are set aside as being either at an undervalue or preferences, there is a risk that the court may make a disqualification order against any director responsible for the transaction concerned in addition to the risk of personal liability.
 - The relevant provisions are explained in more detail in paragraphs below.

The above list is not intended to be an exhaustive list of directors' duties but to highlight those which may be particularly relevant when the solvency of the Company may be in issue. Other normal duties should not be overlooked, for example, the duty to keep adequate accounting records, the duty to act within powers, the duty to exercise reasonable care, skill and diligence,

the duty to declare an interest in transactions or arrangements with the Company, the duty not to accept benefits from third parties, etc. It should be pointed out that all such duties fall equally on executive and non-executive directors.

DIRECTORS' POTENTIAL PERSONAL LIABILITIES

- Wrongful trading
 - Where a company has gone into insolvent liquidation, a director or shadow director can be required to make a contribution to the company's assets. The Court may make such a contribution order if the liquidator can show that before the commencement of the winding-up that person knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation.
 - It should be noted that this provision does not merely cover "trading" activity. Any kind of act, or failure to act, unless it minimises losses to creditors, may attract liability under this section.
- Purpose of the section
 - This provision, introduced by the Insolvency Act 1986, is the principal means of deterring directors from continuing to trade where there is no reasonable prospect of the company avoiding insolvent liquidation. It does so by imposing personal liability on directors.
- The defence
 - The only defence open to a director is that he took every step with a view to minimising the potential loss to the company's creditors that he ought to have taken. This assumes that he knew or ought to have known that there was no reasonable prospect that the company would avoid insolvent liquidation. The onus is on the director to prove this defence.

- The standard expected
 - A director is deemed to know facts which ought to have been known or ascertained by a reasonably diligent person having regard to:
 - the general knowledge, skill and experience that can be reasonably expected of a person carrying out the functions of a director (i.e. "the reasonable company director"); and
 - the general knowledge, skill and experience that he in fact possesses.
 - The same "knowledge" test applies to the conclusions that the director ought to have reached as to the impending insolvency and, in the context of his defence, the steps he ought to have taken to minimise the loss to creditors.
 - There is no requirement to prove intent, dishonesty or fraud. The standard of proof is the civil standard of a balance of probabilities only. There is no requirement for positive misconduct; mere inadvertence can give rise to liability if the liquidator can show that the director knew or ought to have known of the impending insolvency.
- The Court's power
 - Once liability is established, the Court has a complete discretion to order a person to make such contribution to the company's assets as the court thinks proper. In each case the Court will either examine the particular financial position of a director and decide what he is able to pay or will examine the extent to which money is required to meet the claims of creditors and make orders against particular directors regardless of their ability to pay. It is likely that which attitude the court takes will depend upon the level of culpability of the director. The sanction for wrongful trading is civil only - no criminal sanctions attach for wrongful trading, although they may if the director acts with an intention to defraud creditors.
- Disqualification
 - If the court makes a declaration under these provisions, it may also make an

order to disqualify the director from being in any way concerned in the management of a company for a minimum period of two years and a maximum of fifteen years.

- Fraudulent trading
 - If any business of the company is carried on with the intent to defraud creditors or for any other fraudulent purpose, the liquidator of the company can apply to the court under section 213 of the Insolvency Act 1986 for a contribution from any person who was knowingly a party to the carrying on of the business in that manner. This provision is not often invoked often since it requires proof of intent to defraud. However, where the directors allow the Company to continue to trade and incur liabilities when they know there is no real prospect that these will be repaid, the directors are at risk under this provision. The provision is wider than the wrongful trading provision in the following respects:
 - it applies to "any persons", not just directors, who were knowingly parties to the carrying on of the business in question; there is no defence of taking steps to minimise loss to creditors; and it attracts a criminal penalty of 7 years' imprisonment or an unlimited fine, or both, as well as civil liability.

OTHER CONSIDERATIONS

When deciding how the Company ought to proceed either to minimise the loss to its creditors or to implement a strategy to avoid a formal insolvency, it is important for a director to consider how those actions will be viewed with hindsight. In particular, any actions should ensure they do not contravene the statutory provisions relating to transactions at an undervalue and/or preference.

- Transactions at an undervalue
 - Where a company has entered into a transaction at an undervalue, the court may make an order under section 238 Insolvency Act 1986 to restore the position to what it would have been if the company had not entered into the transaction. A director who is responsible for a company entering into a transaction at an undervalue, may be disqualified from being included in any way in the management of a company for a minimum period of two years and a maximum of fifteen years.

- Definition of an undervalue
 - A transaction will be regarded as being at an undervalue if the company does not receive any consideration for the transaction or the value of the consideration it does receive is significantly less than the value of the consideration it provided. A transaction is defined to include "a gift, agreement or arrangement", and examples include:
 - the purchase of an asset the value of which is significantly less than the price;
 - selling an asset for a price significantly less than its value;
 - agreeing to pay for services a sum significantly more than their value;
 - gratuitous payments to employees; and

- guaranteeing a debt due from another group company.
- Circumstances when transactions can be set aside
- Before a transaction can be set aside the following conditions must be satisfied:
 - the company must go into liquidation or administration;
 - the transaction must be at a "relevant time", i.e. within two years before the commencement of the liquidation or administration;
 - the company must be unable to pay its debts at the time or become unable to pay its debts as a consequence of the transaction (but see below);

application to the court for an order must be made by the liquidator or administrator.

It should be noted that a company is deemed unable to pay its debts if it is proved that the value of the Company's assets is less than the amount of its liabilities taking into account its contingent and prospective liabilities.

Connected Person

If the transaction is with a "connected person", the company is presumed to be unable to pay its debts. It is therefore much easier to establish that a transaction was at an undervalue if a connected person is involved. A connected person is very widely defined and includes directors, shadow directors, their "associates" (employers, close relatives, partners), and associates of the

Company (other group companies).

Defence

A defence will be available if the court is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business and at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company. This defence protects a wide range of bona fide business transactions that might otherwise be vulnerable, although there must be reasonable grounds for the belief that the transaction in question would benefit the company.

Transactions outside the scope of directors' powers

A transaction at an undervalue may be set aside even though it does not strictly fall within this section. A transaction entered into with shareholders which is either a gift or at an undervalue may be regarded as an unlawful distribution of capital. This problem is considered below in paragraph 3.4. The directors should also consider whether any corporate benefit follows from a transaction, having regard, where there is a serious question as to the Company's solvency, to the interests of creditors.

Transactions defrauding creditors

Where a person enters into a transaction at an undervalue, the court may make an order under section 423 of the Insolvency Act 1986 to restore the position to what it would have been if the transaction had not been entered into, and to protect the interests of persons who are victims of the transaction. The court must be satisfied that the transaction was entered into for the purpose of putting assets beyond the reach of a person who is making, or may at some time make, a

claim against him, or of otherwise prejudicing the interests of such a person in relation to a claim.

There is no time limit before which transactions cannot be set aside under this section.

Preferences

Where a company has given a preference, the court may make an order under section 239 Insolvency Act 1986 to restore the position to what it would have been if the company had not given the preference. A director who is responsible for a company giving a preference may be disqualified from being involved in any way in the management of a company for a minimum period of two years and a maximum of fifteen years.

Definition of preference

A "preference" occurs where a company does anything, or allows anything to be done, which puts one of the company's creditors, sureties or guarantors into a better position than he would have been in if that act had not been done. Examples of preferences include:

payment of one creditor in full or in part when others remain unpaid; and

granting security in respect of existing debts.

Circumstances in which transactions can be set aside

Before a preference can be set aside, the following conditions must be satisfied:

the company must go into liquidation or administration;

the transaction must be at a "relevant time", i.e. within six months before the liquidation or administration;

the company must be unable to pay its debts at the time or become unable to pay its debts as a consequence of the transaction; and

application to the court for an order must be made by the liquidator or administrators.

It should be noted that a company is deemed unable to pay its debts if it is proved that the value of the company's assets is less than the amount of its liabilities taking into account its contingent and prospective liabilities.

Desire to prefer

A transaction can only be set aside under this provision if the company was "influenced by a desire" to put the creditor surety or guarantor in a better position. It is not sufficient, in order to prove that a company was influenced by a desire to bring this about, for the liquidator or administrator to show that the company was merely aware that the transaction would put a creditor in a better position - a positive wish to achieve this end is needed. Thus, in our view, a transaction entered into for a proper commercial reason should not fall within this provision.

A liquidator or administrator will generally look very carefully at transactions which benefit directors, either directly (e.g. paying directors' salaries, loan accounts etc) or indirectly (e.g. paying off an overdraft guaranteed by directors). Requests by banks to secure current loans need to be examined with this principle in mind.

Connected person

If the transaction is with a "connected person" (see definition in paragraph 3.2.3 the "relevant time" during which transactions are at risk is extended to two years before the onset of insolvency, and the company is presumed to have been influenced by a desire to put the creditor in a better position.

Unlawful capital distributions

Transaction with or payment to a shareholder may also be regarded as an unlawful distribution of the company's assets. Assets may be distributed to a company's members only if there are profits available for this purpose (i.e. accumulated realised profits less accumulated realised losses). If there are insufficient distributable reserves, a transaction with or payment to a shareholder could constitute an unlawful distribution of capital.

A director of an insolvent company is under a duty to have regard to the interests of creditors. There is accordingly a risk that any gratuitous distribution of assets will be a breach of that duty. Such a breach cannot be waived by the shareholders.

Disqualification of directors

A director of a company which became insolvent whose conduct makes him unfit to be involved in the management of a company in future may be disqualified from becoming involved in the management of a company for a period of between 2 and 15 years. An application for a disqualification order can be made within two years of a company becoming insolvent. The matters to be taken into account by the court will include misfeasance, breach of fiduciary duty, misapplication of company property, the director's responsibility for entering into any transaction liable to be set aside under the provisions described in this memorandum, and failure to comply with the accounting and registration requirements of the Companies Act. Incompetence, as well

as commercially or morally culpable behaviour, can be sufficient to enable the court to disqualify a director. A public register of disqualified directors is kept.