# Advising the Board on **Insolvency Risk**

Reports looking at the full range of commercial risk

Risk, Resilience and Reputation

# Directors' risk report

It is crucial for company directors to understand how their duties change and augment in times of financial distress for the company. If these duties are not properly discharged, it can result in personal liability and/or disqualification from acting as a director.

It's equally important to be cognisant of directors' duties if you represent a third party dealing with a distressed company, for example, a lender, supplier or customer. This will help you anticipate how the distressed company may behave in its ongoing dealings and negotiations with you.

Specifically, the fiduciary duties of directors of a distressed company may be a key factor in determining:

- the time available for key stakeholders to agree the terms of a financial restructuring before the board has no real choice but to file for insolvency protection; and
- what the company may and may not be able to do pending a deal being agreed, during what is often described as the 'twilight zone'.

## High profile insolvencies and scrutiny of directors' conduct

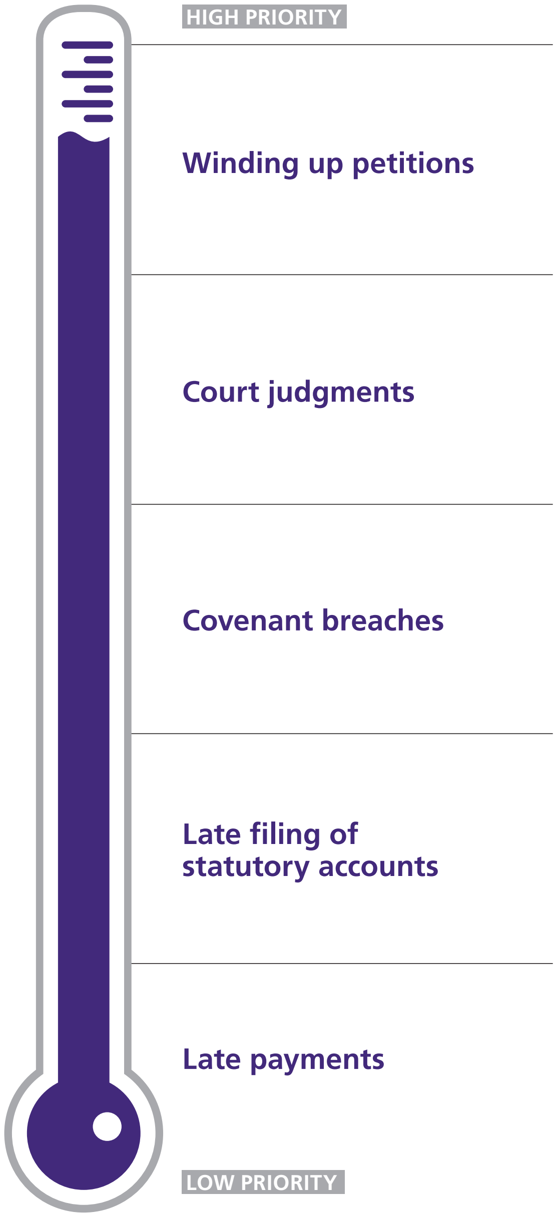
The number of formal insolvencies in the UK has been trending upwards with high profile failures from the last few years including Carillion, Toys R Us, House of Fraser, HMV and Patisserie Valerie. Brexit is presenting further challenges across numerous sectors.

Some of the higher profile corporate failures have attracted extensive public interest and resulted in wide-ranging scrutiny of their directors' conduct by insolvency practitioners, regulators, select committees and others.

In response, the government proposes new laws intended to improve corporate governance. The proposals include plans to hold directors liable if they sanction a sale of a subsidiary company which enters a formal insolvency process within the 12 month period after the sale. Directors may be liable if, at the time of the sale, they did not have a reasonable belief that the sale would likely deliver no worse an outcome for the subsidiary's stakeholders than placing it into a formal insolvency.

The government also plans to make directors personally liable for company taxes if the company deliberately enters insolvency to evade or avoid paying the tax.

## Insolvency flags thermometer – practical examples



# A client's perspective

**Steve Hutchinson**
CFO
UK Coal during two phases
of restructuring

**When a financial crisis hits, what are the most important initial steps for directors to take?**

— quickly identify the root of the problem and the company's restructuring/turnaround options;
— build the right senior management and professional teams to help manage the situation;
— create a stable environment for trading to continue and a runway for a restructuring/ turnaround plan to be worked up and implemented (e.g. standstill arrangements with key creditors); and
— identify which stakeholders are key to delivery of the plan and how to get their buy-in.

**From your experience, what's the secret of a successful restructuring?**

— understanding the issues and having a clear strategy for dealing with them;
— underpinning the restructuring/turnaround plan with a credible and convincing commercial proposition;
— understanding the stakeholder dynamics and managing these effectively;
— strong communication and co-ordination – between management, advisers and key stakeholders;
— pro-active cash-flow management; and
— maintaining focus on normal business, as well as the restructuring/turnaround plan.

**What additional tip(s) would you give to boards facing corporate distress?**

— make optimum use of the specialist advisers – good advisers will have seen the pitfalls before and can help you navigate them;
— retain control of decision making - directors know their business better than anyone and must take responsibility for decisions;
— keep matters under review – unexpected developments will occur and plans will need to be re-visited;
— keep team morale and well-being high on the agenda – encourage rest time because it can be a long road;
— when dealing with stakeholders, be prepared, polite, and if necessary, patient and persistent; and
— always have a plan B, because plan A may not be deliverable despite everyone's best efforts.

## The duty to take into account creditors' interests

Ordinarily, directors have a statutory duty to promote the success of the company for the benefit of its shareholders. However, when a company is in the zone of insolvency, directors are required to consider and act in the interests of the company's creditors.

How financially distressed does a company need to be for the duty towards creditors to arise?

— directors are obliged to have regard to the interests of creditors when they know, or should know, that the company is or is likely to become insolvent. 'Likely' for these purposes means 'probable'; and
— the trigger, therefore, is at some stage before the company actually becomes unable to pay its debts as they fall due.

## Is the board obliged still to balance the interests of shareholders alongside the interests of creditors?

— this issue remains to be fully determined by the courts;
— it is most likely that the answer lies in applying a sliding scale approach;
— when the probability of insolvency is just over 50%, then the duty towards creditors sits alongside the duty towards shareholders; and
— when insolvency is much more likely, creditors' interests are probably paramount.

*REMEMBER: A breach of duty by a director can result in a claim against a director personally.*

# Wrongful trading

The most notorious of civil liabilities faced by directors of companies in financial difficulties is for wrongful trading. Key points to know are:

— a claim for wrongful trading cannot be brought unless the company enters insolvent administration or liquidation;

— a claim can be brought by an administrator, a liquidator, or a purchaser of the claim;

— a court would need to be persuaded that, at some point before the administration or liquidation, that the director *knew or ought to have concluded* that there was no reasonable prospect that the company would avoid going into insolvent administration or liquidation;

— it is a good defence for a director to show that he/she took every step with a view to minimising the potential loss to the company's creditors (noting that this is a very high bar to meet); and

— if found liable, the court can order a director to make such contribution to the company's assets as the court thinks proper.

The courts do not expect directors to have a 'crystal ball' but they do expect directors to be able to show that they had rational expectations of what the future may have held rather than 'wilfully blind optimism'.

When we are advising a board of a company that is in the zone of insolvency we often attend board meetings to help the board navigate the risks. A key part of this is ensuring that the directors apply their minds to the 'reasonable prospect' test and rigorously probe their own rationale for the conclusions they reach.

# What every director should know

— **legal duties** – the same legal duties are owed by all directors, whether one is an executive director, non-executive director, *de facto* director or shadow director;

— **duties are entity specific** – each company in a group (and its respective creditors) must be considered separately;

— **conflicts** – specific steps may need to be taken to address conflicts of interest that may arise, e.g. from a director being on more than one board of different group companies, or also employed by a shareholder or a lender;

— **transactions with connected parties** – directors should ensure that all such transactions are demonstrably on an arm's length basis and undertaken for sound commercial reasons;

— **resignation** – it is generally not advisable for a director to resign without having first discharged his/her duties;

— **listed companies** – companies with listed shares or other securities will have additional obligations, including to update the market;

— **regulated companies** – will have additional obligations (which are outside the scope of this report); and

— **operations abroad** – a UK company that operates or has assets in a jurisdiction outside the UK can enter a local law insolvency process. The directors' conduct may be scrutinised under that local law. Therefore additional local law advice on directors' duties may be required.

# The restructuring toolkit

Sometimes a consensual restructuring can be achieved by negotiation with key stakeholders, without needing to deploy a formal process. Other times a formal process may be needed to force compromises or other solutions. The UK has a collection of mature, tried and tested restructuring tools and techniques, including the following:

**Company voluntary arrangement ('CVA')**

— statutory procedure that can be used to compromise amounts owed to unsecured creditors;

— needs the support of 75% by value of unsecured creditors voting on the company's proposal to become binding on all unsecured creditors;

— can be used before a company is insolvent, but insolvency must be a real risk to persuade enough creditors to vote in favour of the company's proposal;

— takes a minimum of 14 days (plus preparation time); and

— currently popular with retailers and restaurant chains proposing so-called 'landlord only CVAs' e.g. New Look, House of Fraser, Giraffe and Arcadia.

**Scheme of arrangement**

— statutory procedure whereby a company can make a compromise or arrangement with its creditors (secured and/or unsecured) or any class of them;

— no insolvency requirement but, as with a CVA, insolvency must be a real risk to persuade enough creditors to support the scheme;

— requires approval of a majority in number and 75% in value of those voting in a meeting of each class;

— if sanctioned by the court, has statutory force and binds all members of the class whether or not they voted in favour; and

— due to high costs, typically used by large companies (UK and overseas), e.g. Apcoa, Primacom.

**Share 'pre-pack'**

— a pre-packaged sale of shares (usually shares in the operating subsidiaries of a holding company);

— a common means of imposing a financial restructuring on non-consenting shareholders and/or junior lenders;

— the sale of the shares is agreed before the company is put into administration and the sale is completed immediately after the administrator has been appointed;

— typically, the sale terms are agreed between only the proposed administrator, management, the senior secured creditor(s) and the buyer (which may be a third party but is often a connected party);

— a key issue is valuation, because the administrator must obtain a fair market value; and

— a recent example is Interserve.

**Business 'pre-pack'**

— a pre-packaged sale of a company's business and assets by an administrator;

— difference from the share pre-pack is that the administrator takes office in relation to the operating company (or companies), rather than a holding company, and the sale is of the business and assets as a going concern;

— liabilities are left behind in the seller(s) other than those that transfer as a matter of law (e.g. employees if a business sale) and those that must be paid by the buyer for commercial reasons; and

— recent examples: Johnston Press, Ince & Co.

# The expert's perspective

**Tom Jordan**
UK Management Liability Manager
AXA XL

**If my business is worried about insolvency can I still buy management liability (D&O) cover?**

The fact that a company is at risk of insolvency, or even already in administration, is not necessarily a bar to getting insurance for potential management liability.

Generally speaking, the cover available is broad. However, insurance cover is only part of a company's overall risk management programme. Directors should seek legal advice to mitigate against the risk of claims arising in the first place, rather than relying solely on insurance. It will be reassuring for an underwriter if a director is assessing the risks they face with suitably qualified professionals.

**Where insolvency is a risk, what information will a D&O underwriter want?**

The placement of every D&O policy is a collaborative exercise between the insured, their broker and the insurer. If insolvency is a risk, there is likely to be closer scrutiny of the company's finances, its relationships with its creditors and any future business plans. Insurers are likely to raise specific queries about any potential issues relevant to the reported financial difficulties. The purpose of this exercise is for everyone to be comfortable with the cover under the policy.

**What is not covered under a D&O Policy?**

In the context of insolvency, D&O policies typically provide cover to directors for claims made by administrators or liquidators as well as for regulatory investigations including by the Insolvency Service, and disqualification proceedings.

However, claims (or circumstances) directors knew about prior to the insurance cover are normally excluded, which might be relevant if an insolvency event has taken place before the cover incepts. D&O policies will also not protect dishonest or fraudulent directors and insurers cannot provide cover for matters that are uninsurable under law such as some fines or penalties, or personal tax liabilities imposed on a director.

# Summary: practical risk management for directors

## Practical steps directors should take to discharge their duties and mitigate the risk of liability:

- Seek specialist advice (legal and financial) early on.
- Keep detailed board minutes.
- Check D&O insurance policy cover.
- Proactively manage cash and credit.
- Ensure all directors have up-to-date information.
- Engage with key stakeholders.
- Hold regular board meetings to assess which duties are in play and whether there is still a 'reasonable prospect' of avoiding formal insolvency.
- Devise a contingency plan to be deployed if a consensual solution cannot be found.

## Contacts

**Martin Brown**
Partner, Restructuring & Insolvency
**T** +44 20 7367 2590
**E** martin.brown@cms-cmno.com

**Glen Flannery**
Partner, Restructuring & Insolvency
**T** +44 20 7524 6867
**E** glen.flannery@cms-cmno.com

**Amit Tyagi**
Senior Associate, Insurance & Reinsurance
**T** +44 20 7367 3578
**E** amit.tyagi@cms-cmno.com

**Hayley Stevenson**
Senior Associate, Insurance & Reinsurance
**T** +44 20 7367 3346
**E** hayley.stevenson@cms-cmno.com

**Sian Aitken (Scotland)**
Partner, Finance
**T** +44 131 200 7385
**E** sian.aitken@cms-cmno.com

**Harriet Munro (Scotland)**
Partner, Insurance & Reinsurance
**T** +44 131 200 7677
**E** harriet.munro@cms-cmno.com

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CMS Cameron McKenna Nabarro Olswang LLP
Cannon Place
78 Cannon Street
London EC4N 6AF

T +44 (0)20 7367 3000
F +44 (0)20 7367 2000



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