

# Companies in distress: directors' duties and helpful tools

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# Managing directors' duties in challenging circumstances

Many businesses are experiencing financial challenges as they grapple with a convergence of headwinds, including supply chain friction, labour shortages, surging inflation and rising interest rates.

When a company is in financial difficulty, the responsibilities and duties of its directors can change, depending on the financial position of the company. At a certain point on the financial decline curve, directors must have regard to the interests of creditors as well as shareholders and there are scenarios in which creditors' interests trump those of shareholders.

Every director should be aware of these issues, particularly if the company they direct has financial challenges. If the applicable duties are not properly discharged, a director can face personal liability and/or disqualification from acting as a director.

An awareness of the issues is also important for directors of healthy companies, for several reasons. Firstly, the financial position of a company can decline quickly, sometimes unexpectedly. Secondly, a healthy company may have commercial dealings with a counterparty experiencing financial difficulty - being aware of the issues will help anticipate how that counterparty may behave in ongoing dealings and negotiations.

## **Directors' duties considerations may influence:**

- whether the company should continue to trade;
- whether to obtain specialist advice (such as contingency planning advice from an insolvency practitioner);
- the time available for key stakeholders to agree the terms of a financial restructuring or other measures; and
- what the company may and may not be able to do pending completion of a restructuring.

In this briefing note, we outline:

- the risks for directors;
- practical steps that can be taken to avoid personal liability; and
- the tools available to help rescue companies in distress.

# Risks for directors

Current and former directors can be held personally liable for breaches of their duties which cause loss.

If a company enters a formal insolvency process, the appointed insolvency officeholder (an administrator or liquidator) will investigate the prior actions of the company's directors.

**Depending on the findings, the following claims or issues may arise:**



breach of duty or other misfeasance



wrongful trading



fraudulent trading



liability arising from entry by the company into transactions at an undervalue



liability arising from entry by the company into preference transactions



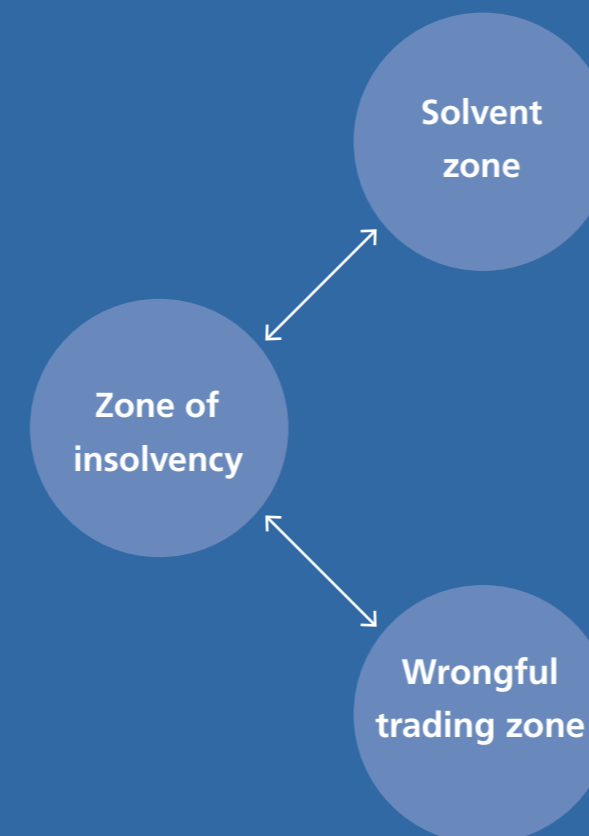
disqualification of directors and compensation orders



# The shifting nature of directors' duties

A director's duties vary according to the financial position and prospects of the company.

In this context, the zones and issues to be aware of are as follows:



## Solvent zone

When a company is solvent, its directors owe a duty to the company to act in a way that they consider, in good faith, will promote the success of the company for the benefit of its **shareholders**.

## Zone of insolvency

If (a) the company is, or is bordering on being insolvent (on a cash-flow or balance sheet basis), or (b) an insolvent liquidation or insolvent administration of the company is probable, directors owe a duty to the company to have regard to the interests of the company's **creditors** as well as the interests of its shareholders.

## Wrongful trading zone

If a company reaches a point at which its directors know, or ought to have concluded, that there is **no reasonable prospect** of the company avoiding an insolvent administration or liquidation (the '**wrongful trading point**'), its directors should take **every available step to minimise potential losses to the company's creditors**.

At all times, directors are required to act within their powers, exercise independent judgement, exercise reasonable care, skill and diligence, avoid conflicts of interest, not accept benefits from third parties, and declare interests in proposed transactions and arrangements.

## 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 (a) the company is, or is bordering on being, insolvent on a cash-flow or balance basis, or (b) an insolvent liquidation or insolvent administration of the company is probable.

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

From the moment the 'creditor duty' is engaged, directors are required to have regard to the interests of creditors as well as shareholders.

Where those interests conflict, directors are required to balance the competing interests. The greater the company's financial difficulties, the more weight should be attached to the interests of creditors relative to the interests of shareholders.

The interests of creditors become paramount (to the exclusion of the interests of shareholders) when insolvent liquidation or insolvent administration is inevitable.

## Wrongful trading

The most notorious of civil liabilities faced by directors of companies in financial difficulty is for wrongful trading.

If a company has reached a point at which its directors know or ought to have concluded that there is no reasonable prospect of the company avoiding an insolvent administration or liquidation (i.e. the 'wrongful trading point'), its directors should take every available step to minimise potential loss to the company's creditors.

This might require a cessation of trade and/or the commencement of a formal insolvency process in an organised manner. The position should be continually and carefully assessed by reference to all the circumstances and options prevailing at the relevant time.

### Key points to know are:



a claim for wrongful trading can only be brought where the company enters insolvent administration or liquidation



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



a court would need to be persuaded that, at some point before administration or liquidation, the wrongful trading point had in fact been reached



it is a defence for a director to show that they 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)



if a director is found liable, the court can order them 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'. However, they do expect directors to be able to show that they had rational expectations of what the future might have held, rather than displaying wilfully blind optimism.

When a company is in the zone of insolvency, it can be helpful for advisers to attend board meetings to help the board navigate the risks. Directors should continually apply their minds to whether there is no reasonable prospect of the company avoiding an insolvent administration or liquidation and rigorously probe their own rationale for the conclusions they reach.

# Other potential claims and consequences

## What is it?

## Consequences

### Breach of duty claim

The company (acting by an administrator or liquidator) can bring a claim against any director who is found to have not properly discharged their duties to the company (including the duty to the company to have regard to the interests of its creditors if that requirement was engaged at the relevant time).

The court can order the director to pay damages to the company for any loss caused by their breach of duty to the company.

The director's breach of duty would also be an adverse factor taken into account in any disqualification proceedings (see below).

### Fraudulent trading

An administrator or liquidator can bring a claim for fraudulent trading where a director allows a company to continue to trade and incur liabilities knowing that there is no real prospect that the liabilities incurred will be repaid.

The court may order a director found guilty of fraudulent trading to make any contribution to the company's assets as it thinks proper.

A director found guilty of fraudulent trading is also liable to imprisonment or a fine, or both, and may be subject to director disqualification proceedings (see below).

### Transactions at an undervalue

An administrator or liquidator can bring a transaction at undervalue claim where a company disposes of an asset for significantly less than its market value.

If liability is established, the court can make an order to restore the position to what it would have been had the transaction not taken place.

In addition, the court can order a director of a company that entered into a transaction at an undervalue to contribute such sum as the court thinks fit by way of compensation.

### Preferences

An administrator or liquidator can bring a preference claim where a company has intentionally put a creditor or guarantor in a better position than it would otherwise have been in.

If liability is established, the court can make an order to restore the position to what it would have been had the preference not been given.

In addition, the court can order a director of a company that has given a preference to contribute such sum as the court thinks fit by way of compensation.

### Disqualification of directors and compensation orders

If a company goes into insolvent administration or liquidation, the administrator or liquidator will investigate the conduct of each director, and anyone who was a director in the previous three years, and submit a report to the Secretary of State on each of them.

The Secretary of State will determine whether there are grounds to bring disqualification proceedings.

An individual can be disqualified from being concerned or taking part in the promotion, formation or management of a company for up to 15 years.

A compensation order can also be made against the individual concerned.

# Key points to note



## Joint accountability

The same legal duties are owed by all directors, whether they are executive directors, non-executive directors, de facto directors or shadow directors.



## Duties are entity specific

Each company in a group (and its respective creditors) must be considered separately.



## Conflicts of interest

Specific steps may need to be taken to address conflicts of interest that may arise, e.g., from a director being on the board of more than one group company, or also employed by a shareholder or a lender.



## Transactions with connected parties

Directors should ensure that all transactions with connected parties 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 their duties.



## Public companies

Companies with listed shares or other securities will have additional obligations, including to update the market.



## Regulated companies

Regulated companies may have additional obligations, e.g. to notify the regulator of relevant events.



## 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, so additional local law advice on directors' duties may be required.

# Practical risk management steps

Each situation will require its own response.

Some practical steps that should be considered in all situations are as follows:

## Specialist advice

Seek specialist legal, financial and contingency planning advice (as appropriate) at an early stage.

## Insurance

Check D&O insurance policy cover and consider whether it should be enhanced.

## Stakeholders

Engage with key stakeholders at the appropriate time. Their support may be critical to ongoing trading and any restructuring proposal.

## Cash management

Proactively manage cash flow and liquidity and carefully consider whether it is appropriate to incur new liabilities.

## Board meetings

Hold regular board meetings to assess which duties are in play and whether there is still a 'reasonable prospect' of avoiding formal insolvency.

## Board minutes

Keep detailed board minutes of board decisions and the rationale for making them.

## Information

Ensure all directors have up-to-date information.

If appropriate, produce accounts and projections on a more frequent or sophisticated basis.

## Contingency plan

Devise a contingency plan to be deployed if a consensual restructuring solution cannot be delivered.

Obtain advice from an insolvency practitioner to assist with this process as appropriate.

# 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 tried and tested restructuring tools and techniques.

## Moratorium ▼

- certain eligible companies can avail themselves of a standalone moratorium that is overseen by a monitor (who must be a licensed insolvency practitioner);
- to commence the process:
  - the company’s directors must declare that the company is unable to pay its debts or likely to become unable to pay its debts; and
  - the monitor must declare that they consider that the moratorium will result in the rescue of the company as a going concern;
- the moratorium gives the company a payment holiday in respect of certain pre-moratorium debts and restrains various types of enforcement action during the moratorium period; and
- this is a “light-touch” procedure in which the directors remain in control of running the business and the monitor oversees the moratorium.

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## Company voluntary arrangement (CVA) ▼

- a statutory procedure that can be used to reduce or reschedule unsecured debts of the company;
- requires the support of 75% (by value of claims) of unsecured creditors voting on the proposal (at least 50% of whom must not be connected to the company);
- if approved, the CVA proposal becomes binding on all unsecured creditors, irrespective of whether or how they voted; and
- the court does not get involved unless there is a challenge to the CVA within a 28-day appeal window after the CVA is approved.

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## Scheme of arrangement ▼

- a statutory procedure that can be used by a company to reduce or reschedule its debts (including secured debts);
- in each voting class, requires the approval of 75% (by value) and a majority in number of those voting;
- voting thresholds must be met for all affected classes;
- requires court sanction; if sanctioned, the scheme binds all members of each class, irrespective of whether or how they voted; and
- due to relatively higher costs, mainly used by large companies (including overseas companies that have a nexus with the UK).

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## Restructuring plan ▼

- a very similar process to the scheme of arrangement, but the eligibility criteria are different and cross-class cram down is possible;
- must satisfy two criteria to be eligible:
  - the company must have encountered, or be likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern; and
  - the purpose of the compromise or arrangement proposed must be to eliminate, reduce, prevent, or mitigate the effects of any of the company's financial difficulties;
- approval of the plan requires 75% (by value) of each affected class to vote in favour (with no requirement for a majority in number), subject to cross-class cram down being possible;
  - through cross-class cram down, the court can exercise its discretion to approve the restructuring plan despite one or more classes voting against the plan, if it is satisfied that:
    - none of the dissenting classes would be any worse off than in the 'relevant alternative', which is defined as what the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned; and
    - the restructuring plan has been approved by 75% by value of at least one class of creditors or members and that class would receive a payment or have a genuine economic interest in the company in the 'relevant alternative' referred to above.

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## Administration ▼

- a statutory procedure that can be initiated by the company, its directors or creditors including secured creditors;
- an administrator (who must be a licenced insolvency practitioner) is appointed and must form proposals with the objective of: rescuing the company as a going concern; achieving a better outcome for creditors than if there were an immediate winding-up; or realising assets to make a distribution to secured and/or preferential creditors.
- often the first objective (company rescue) is not achieved. Administration is more often used as a process to achieve a better realisation for creditors than in an immediate liquidation;
- the asset realisation process can be organised as a 'pre-pack' sale, i.e. one in which the sale is negotiated confidentially prior to administration and then executed by the company acting by its administrator as soon as he/she is appointed (see below);
- during the administration, the company benefits from a moratorium against various enforcement action and legal process being commenced or continued against the company or its assets without consent of the administrator or permission of the court.

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## Share 'pre-pack' ▼

- a pre-packaged sale of shares (usually shares in the operating subsidiaries of a holding company);
- the sale of the shares is agreed before the company is put into administration and completed immediately after the administrator has been appointed;
- a common means of imposing a financial restructuring on non-consenting shareholders and/or junior lenders; and
- a key issue is valuation, because the administrator must obtain a fair market value for the shares being sold.

# The restructuring toolkit

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## Business 'pre-pack' ▼

- a pre-packaged sale of a company's business and assets by an administrator;
- the difference between this and a 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; and
- liabilities are left behind in the seller company or companies other than those that transfer automatically by operation of law (e.g. employee liabilities) and those that the buyer elects to assume for commercial reasons.

# A business perspective

## Steve Hutchinson

Former Chief Financial Officer at 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).
- 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.
- Proactive cash flow management.
- Maintaining focus on normal business, as well as the restructuring/turnaround plan.

### What additional tips 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 revisited.
- 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.
- Always have a plan B because plan A may not be deliverable despite everyone's best efforts.

# An insurance perspective

## 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, in principle, not necessarily a bar to getting insurance for potential management liability. However, in recent years the D&O market has significantly hardened and companies that are perceived to be distressed will find it more challenging to identify insurers willing to underwrite the risk.

— 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 the directors are 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.

— 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 incept. 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.

# Contacts



**Sian Aitken**

Partner

**T** +44 131 200 7385

**E** [sian.aitken@cms-cmno.com](mailto:sian.aitken@cms-cmno.com)



**Martin Brown**

Partner

**T** +44 20 7367 2590

**E** [martin.brown@cms-cmno.com](mailto:martin.brown@cms-cmno.com)



**Glen Flannery**

Partner

**T** +44 20 7524 6867

**E** [glen.flannery@cms-cmno.com](mailto:glen.flannery@cms-cmno.com)



**Timea Scholey**

Partner

**T** +44 20 7367 2519

**E** [timea.scholey@cms-cmno.com](mailto:timea.scholey@cms-cmno.com)



**Peter Wiltshire**

Partner

**T** +44 20 7367 2896

**E** [peter.wiltshire@cms-cmno.com](mailto:peter.wiltshire@cms-cmno.com)



**Julian Turner**

Consultant

**T** +44 20 7067 3552

**E** [julian.turner@cms-cmno.com](mailto:julian.turner@cms-cmno.com)



**Jennifer Antonelli**

Of Counsel

**T** +44 131 200 7630

**E** [jennifer.antonelli@cms-cmno.com](mailto:jennifer.antonelli@cms-cmno.com)



**Kelly Rothwell**

Of Counsel

**T** +44 20 7367 3857

**E** [kelly.rothwell@cms-cmno.com](mailto:kelly.rothwell@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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