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Companies in difficulty: issues for directors

Two recent cases have dealt with similar concerns relating to the personal liability of directors for the liabilities of their insolvent companies, but with very different results. The decisions illustrate the type of conduct likely to lead to personal liability for wrongful trading, but also how a board can continue to trade through financial difficulties without attracting personal liability.

Background

The principle of limited liability means that, generally speaking, directors of limited liability companies are not personally responsible for the debts of those companies. There are various ways in which personal liability can arise – most commonly this will be because a major creditor (generally a bank and/or landlord) will require a personal guarantee.

However, directors of companies in financial difficulty need to be particularly careful. If that company eventually enters insolvent liquidation there is a real risk that, in order to maximise the assets available to creditors, a liquidator will bring a claim against the director.

Possible claims

The most likely claims, assuming there is no question of genuine fraud or dishonesty, are:

- A claim of "wrongful trading" under s.214 of the Insolvency Act 1986, where a liquidator applies to the court for an order that a director make a contribution to the insolvent company's assets on the basis that the board allowed the company to trade past the point at which there was <u>no reasonable prospect of the company avoiding insolvent liquidation</u>.

- A claim that a director has breached their directors duties, most relevantly the duty to act in the best interests of the company (which for a company in severe financial difficulties should be regarded as the interests of its creditors), and the duty to use reasonable care and skill in carrying out the function of a director.

There is no offence of simply continuing to trade whilst a company is insolvent, whether on a balance sheet basis (i.e. the company's liabilities are greater than its assets), or a cash flow basis (i.e. the company is able to pay its liabilities as and when they fall due).

The cases

In February the High Court decided *Philip Roberts (acting as liquidator of Onslow Ditching Limited) v Frohlich and Spanner [2011] EWHC 257.* The case related to a property SPV company which had been financed entirely by borrowing. The company ("ODL") had acquired property for development as industrial trading units. ODL became involved in a

dispute with its main contractor who eventually suspended work on the project. ODL did not tell its bankers about this immediately, and its bankers continued to honour further payments made by ODL. ODL subsequently entered administration and then insolvent liquidation.

Last month the High Court decided *In the matter of Langreen Ltd*. The case related to a company which had been established to utilise satellite technology to offer broadband internet access to rural areas in the UK, which at the time were largely ignored by other providers. The company struggled throughout its existence and the judge found that it was always undercapitalised and had cash-flow problems. However, in January 2006 its main supplier of satellite services had switched off its supply on less than 3 hours notice. The directors promptly informed customers and its bankers that the company would cease to trade, and called in a firm of accountants and insolvency practitioners. (In *Langreen* only a wrongful trading claim was brought, and so the remainder on this article focuses on wrongful trading. However, similar principles also apply to liability for breach of duty.)

The lessons

In *Onslow Ditching* the court upheld all the claims against the directors brought by the liquidators, including wrongful trading. However, in *Langreen* the court rejected the arguments brought by the liquidator and made no order against the directors concerned. So what factors did the court take into account and why were the decisions different?

General approach

The cases reaffirm the basic principle that when it considers directors' pre-liquidation conduct for the purposes of a wrongful trading claim, the court acknowledges that it is doing this with the benefit of hindsight. It will not necessarily look to impose sanctions on directors because they took an honest and rational commercial decision which turned out to be wrong. The conduct necessary to establish liability needs to be more than this, although it is not necessary to show dishonesty or fraud (there are other more serious offences which cover that type of conduct).

Generally, where directors make a determined effort to understand the position which the company is in and take rational decisions based on this which they believe are in the best interests of the company and its creditors, they are unlikely to attract liability. When a company is in financial difficulty the directors face a very difficult decision as to when and if to enter a formal insolvency procedure – doing so too early is much less likely to lead to legal liability, but may lead to strong criticism from other stakeholders, as the company will almost certainly be wound up on an insolvent basis and creditors will not be paid in full.

Conduct likely to lead to liability

The conduct which will generally lead to liability for wrongful trading is where the directors do not act on the basis of rational expectations as to what the future might hold, and are, for example, blindly optimistic that "something will turn up", or where the board refuse to investigate the company's position and try and ignore the risk of insolvency.

In *Langreen* the court was satisfied that the directors at all relevant points had been acting rationally, were exploring new business opportunities for the company and could have a reasonable belief that the company could trade out of its difficulties and avoid insolvent liquidation. In *Onslow Ditching* however, the court found that the directors could not have honestly believed after September 2004 that ODL could trade out of its difficulties. The court summarised its findings in the following paragraph:

"What drove [the directors] at this stage was wilfully blind optimism; the reckless belief that, provided they did not enquire too deeply into the figures, provided ODL did not let on to [the contractor] that there was no funding and did not let on to [its bankers] that there was no fixed price contract, then something might turn up, if only because [the contractor and the bank] could be sucked into the development to such a degree that, in order to salvage something, they would crack under pressure and would "share the pain". But the hope that "something might turn up" was on any objective view groundless and forlorn. Insolvent liquidation was inevitable".

Conclusion

These cases are helpful reminders of the problems which directors of companies which are in financial difficulties face. In particular, turning a blind eye to the company's situation and refusing to engage with the issues, or relying on "blind optimism" that things will turn around, can lead to serious consequences. Equally however, the *Langreen* case reaffirms the basic principles used by English courts to approach these issues, and that a board who act rationally, on an informed basis and in good faith are unlikely to suffer personal liability simply because the company eventually goes into insolvent liquidation.

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