May 9, 2019

Practical advice for directors of distressed companies

Attorneys
Daniel Andrews
Frederick Doust

In normal circumstances, a director's primary duty (owed to the company, not the company's shareholders or the corporate group) is to promote the success of the company for the benefit of its shareholders as a whole. When a company enters a period of financial distress (the so-called "*zone of insolvency*") there is a shift of emphasis in the duties of the directors: directors must consider the interests of the company's creditors and, depending on the extent of the financial distress, may need to prioritise such interests over those of its members.

In particular, directors must be mindful to minimise potential losses to creditors and can incur personal liabilities for failing to do so (for wrongful trading, fraudulent trading, misfeasance, breach of duty, etc.).

Wrongful Trading

It can be difficult for directors to determine whether continuing to trade in the hope of improving the company's economic position (for example, by agreeing a restructuring of its debts) or whether ceasing trading would be in the best interests of the creditors.

A director who concludes (or ought to have concluded) that insolvent liquidation cannot reasonably be avoided may be held liable by court order for losses caused to the company. Accordingly, directors of distressed companies should regularly ask themselves the question "*is there a reasonable prospect of avoiding insolvent liquidation?*" If the answer is ever "*no*", every step should be taken by the directors to minimise creditors' losses. Some practical advice for directors in this situation is set out below.

- **Continuing to trade**

  There is no need to cease trading as soon as financial difficulties commence. As noted, as long as directors determine that there is a *reasonable prospect of the company avoiding insolvent liquidation*, they may continue to trade and doing so may well be the best way to maximise potential returns to creditors (for instance, where a debt restructuring is agreed that enables the business to continue as a going concern).

- **Regular board meetings and minutes**

  Board meetings should be held on a regular basis during periods of financial distress to focus on the company's viability and its chances of avoiding insolvent liquidation. In relation to a group of companies, meetings should be held for all potentially affected companies. Appropriate information about budgeting and cash flows should be considered, and directors should ensure that prompt action is taken in relation to any breaches or potential breaches of finance documents or other contractual obligations. The deliberations and decisions of the board should be minuted in detail (including any dissenting voices amongst the directors), addressing the interests of all stakeholders, so that it can be demonstrated if necessary that the directors were acting reasonably in continuing to trade through the period of distress.

- **Appropriate advice**

  The board should engage appropriate professionals (such as lawyers, accountants and financial advisors) to advise on whether the company should continue to trade and the ways in which the financial distress could be addressed and alleviated. A comprehensive review of debt facility documentation should be undertaken with advisers and directors should pay particular attention to any financial covenant obligations and potential triggers or breaches.

- **Business Review**

  Directors should review the company's business and determine if expenditure can be reduced and cash flows increased (for example through disposals, altering terms with customers and suppliers, utilising undrawn debt facilities, reducing headcount etc.). Relevant baskets in the finance documents should be considered in this context.

- **Appropriate division of responsibility**

  The board should consider whether a committee should be constituted to focus exclusively on the restructuring of the company (which can be very time-intensive), whilst other directors direct their attention towards the day to day operation of the business. Directors should be mindful of any conflicts of interest which may arise (for example, as a result of a relationship with a private equity sponsor) and ensure that any such conflicts are declared and appropriately managed.

- **Engage with stakeholders**

  Directors should engage with creditors at an early stage to ensure that they are (and remain) well informed of the company's financial position and remedial actions being pursued by the directors. Ideally this engagement should happen well in advance of any requests being made to the creditors for deferral of covenant testing, waivers of actual or anticipated breaches, etc. Directors should also continue to discuss the company's position with its shareholders and, in particular, explore whether there is any possibility of those shareholders investing new money as part of a restructuring. Directors may also consult with material creditors on the merits (or otherwise) of continuing to trade.

- **Contingency planning**

  Directors should work with legal advisers to explore alternatives, such as administration, in the event that a rescue of the business outside of a formal insolvency process is not possible.

Proposed legislative changes

Note that the government plans to implement certain changes to the UK's corporate governance framework, which may impact on directors' liability in the context of distressed companies. These changes will be legislated "*when parliamentary time allows*", and include the following proposals:

- Sales of businesses in distress: the government intends to adopt a measure which may impact holding company directors where such holding company proposes to sell a financially distressed subsidiary. Broadly, if the relevant subsidiary enters insolvent liquidation or administration within 12 months of such sale, directors who did not give "*due consideration*" to the interests of the subsidiary's stakeholders may run the risk of personal liability and disqualification. For more detail on this proposed change, please see our article.

- Value extraction schemes: this would be a new form of potential claw-back available to insolvency practitioners. Where a company enters administration or liquidation, an administrator or liquidator could review a transaction entered into in the two-year period prior to such administration or liquidation, pursuant to which a director or shareholder has made a loan to the financially distressed company for the purpose of "extracting value" from the company (by, for instance, disproportionately high interest rates or security on the loan).

The detail of these changes remains to be finalised; we will continue to track new developments.

For further information on any of the issues outlined above, please contact Dan Andrews.