
Directors' Responsibilities: Avoiding the Wrongful Trading Trap

A company directorship offers many benefits when the business is doing well.

But directors also carry a heavy burden of responsibility for the way their companies operate.

Directors who, either intentionally or through neglect or incompetence, fail to meet their obligations could face personal claims, bankruptcy or disqualification and even, in the rare cases where fraudulent trading can be proved, imprisonment.

Thomson Snell & Passmore has prepared this information sheet in order to answer some of the most frequently asked questions on the subject of wrongful trading.

Insolvency And Wrongful Trading

It is a basic fact of business life that companies fail and are put into liquidation. The reasons for liquidation are many and varied but the concern of the law in all such cases is to provide the maximum protection for creditors of a company in liquidation.

What is wrongful trading?

In simple terms, wrongful trading occurs when the directors of a company continue to trade when they should have realised that there was no prospect of avoiding insolvent liquidation and do not act to minimise losses, and the company then goes into liquidation.

Insolvent liquidation occurs if, when a company goes into liquidation, its assets are not sufficient to pay its debts and liabilities and to pay the costs of liquidation.

How can I judge whether we are insolvent or may become insolvent?

Accurate day-to-day financial information should provide a good indication of a company's financial state.

When this information indicates a possibility of insolvency, a responsible director will:

- Carry out detailed analysis of the financial situation.
- Seek professional advice from an Insolvency Practitioner or the company's auditors and/or solicitors.

You should ask yourself:

- Can the company continue to pay its debts at or close to the time they are due?

- Does the value of the company's assets exceed its liabilities, including those likely to be incurred in the future and those which may be incurred unexpectedly?
- If the company were liquidated right now, could it meet all its liabilities in full, including the cost of debt collection and liquidation?

If the answer to any of these questions is no, the company is almost certainly insolvent. Its directors must make a critical judgment as to the likelihood of insolvent liquidation being avoided. The judgment must be made quite clinically, without emotion and avoiding exaggerated optimism or pessimism.

Once you reach a point where you know - or where a reasonable director ought to know - that it is unlikely that insolvent trading can be avoided, everything possible must be done to minimise loss to the company's creditors. At this point the directors need to put the company's creditors' interests before those of its shareholders.

Should we stop trading right away if we think we are insolvent?

Not necessarily. You may feel that the company can trade back into solvency and a decision to carry on trading may in certain circumstances be justified.. However, it is essential that you take expert financial and legal advice on this point. If you are eventually faced with a wrongful trading summons, it will be easier to prove that you have acted reasonably if you can demonstrate that the decisions taken were based on professional advice.

I am only the sales director and simply don't have as much knowledge or expertise as the others. Surely they would be liable and I would not?

As sales director you will be judged against the standard of the 'reasonable' director which applies to all directors and shadow directors.

However, the onus on you would not normally be as great as upon the managing director, who is seen to have a greater level of general skill and responsibility, or the finance director who will be assumed to have a higher level of specialist skill and experience.

Any director, however, is more vulnerable to being held liable if it can be shown that he or she has relevant specialist skills which they have failed to apply.

I think that we are in trouble. Can I resign now and avoid liability?

Absolutely not. If you held a directorship at the crucial point where it should have been clear that insolvent liquidation was inevitable, you cannot escape by resigning.

Although I feel it is impossible to avoid insolvent liquidation, my colleagues disagree and the board is split. What should I do?

While you cannot avoid liability by resigning, you should certainly not stay silent. You must ensure that your views are placed on record.

- Make an appeal to shareholders for a general meeting.
- Persuade the board to consult an Insolvency Practitioner.
- Persuade a shareholder to submit a petition under the Companies Act claiming that the company's affairs are being conducted in a manner unfairly prejudicial to the interests of one or more shareholders.

If the board continues to mislead shareholders and creditors, you should immediately take advice as to other steps which can be taken to distance yourself from your fellow directors.

When should we take professional advice?

For maximum protection, seek legal and accountancy advice as soon as you are aware that the company has serious problems.

If we take advice and things get worse, are we in the clear?

Aside from the beneficial practical advice offered by legal and financial professionals, the simple fact that you have sought advice helps to show that you have acted reasonably.

If we go into liquidation, can we start again using the same or a similar name?

Definitely not. Any individual who has been a director of a company in the 12 months prior to liquidation is banned for five years from starting up a company using the same or a similar name.

Other than financial liability, what other consequences are there?

If a director is found liable for wrongful trading the Court may in some more serious cases find him unfit to be a director. Consequently, he may be disqualified from being a director, or setting up or managing a company.

In addition if a director is disqualified and continues to act as a director he may be liable for part or all of the debts of the company.

“de facto” directors (i.e. persons who are not appointed as directors but who directly assume control of aspects of a company's business) and “shadow” directors can also be disqualified.

The length of the disqualification depends on the extent of the individual director's responsibilities for the insolvency. The average period of disqualification is between two and five years.

The rate of disqualification has been increasing -632 were disqualified in 1995 and 1,470 in 1999.

Fraudulent Trading

Although the number of cases prosecuted is small, a separate offence of fraudulent trading exists. The offence will be used to prosecute individuals in those cases where deliberate fraud, rather than negligence or incompetence, results in insolvent liquidation.

As well as being made financially liable for all or part of a company's debts, directors who are successfully prosecuted for fraudulent trading may be imprisoned.

Conclusion

The legislation governing wrongful trading is aimed at ensuring that, when a company goes into insolvent liquidation, it is the unreasonable and irresponsible directors of that company who shoulder the burden of losses, not the innocent creditors.

Every director must realise that, whatever their level of seniority or influence on a company's board, they may be held responsible for the company's performance. It is, therefore, in the interest of every director to insist on receiving the quality of information required to make informed financial judgements.

A less extensive duty of care is required of directors of smaller companies with simple accounting procedures than is required of directors of larger companies with more sophisticated systems.

While some insurance companies offer some degree of protection against wrongful trading liabilities, the best insurance is an awareness of the pitfalls, full and accurate accounting and management systems and recourse to expert professional advice.

Although this information sheet highlights many of the key issues concerning directors' responsibilities, it is intended for general guidance only and can be no substitute for considered advice on specific problems. It is based upon our understanding of the legal position as at 1 October 2000 and may be affected by subsequent changes in the law. It should not be considered comprehensive.

Should you require any further detailed information about the issues covered, or have any other concerns about exercising your responsibilities as a director, simply e-mail James Partridge at james.partridge@ts-p.co.uk or call on 01892 510000.