

## Directors' responsibilities: Avoiding the wrongful trading trap

### Introduction

The position of company director offers many benefits when the business is doing well. At the same time, directors carry an increasingly heavy burden of responsibility for the way their company operates and are subject to an extensive menu of duties, particularly under the Companies Act 2006.

Directors who, either intentionally or through neglect or incompetence, fail to meet the standards expected of them can face personal claims to compensate the company, bankruptcy or disqualification and even, in rare cases of fraudulent trading, 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 in relation to private limited companies.

### 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 cases of insolvency is to provide the maximum protection for the creditors of the company in liquidation.

#### 1 What is wrongful trading?

In simple terms, wrongful trading occurs where the directors of a company continue to trade when they knew or should have realised that there was no reasonable prospect of the company avoiding insolvent liquidation and the company then goes into liquidation.

The liquidator would not have to prove that a director was dishonest in acting in the way that they did. This means that the burden of proof is lower.

It is the liquidator of the company who makes the application to Court. However, a Court will not make an order for wrongful trading if the directors can be said to have taken every step with a view to minimising the potential loss to the company's creditors.

#### 2 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;
- Ensure that up to date financial information is obtained on a daily basis;
- Check the terms of any loans to monitor compliance with financial covenants in the documentation;
- Ensure that regular and detailed board meetings are held;
- Seek professional advice from an Insolvency Practitioner or the company's auditors and/or solicitors.

In those circumstances, you should ask yourself:

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

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## Directors' responsibilities:

### Avoiding the wrongful trading trap (continued)

- 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 then 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 director ought reasonably to know - that it is unlikely that an insolvent liquidation 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.

#### **3 Should we stop trading right away if we think we are insolvent?**

Not necessarily. The fact that a company's debts are greater than its assets does not mean that the company will go into insolvent liquidation. Case law suggests that liability for wrongful trading will only arise if, on a net basis, it is shown that the company is worse off as a result of the continuation of trading.

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 were taken having first obtained professional advice.

#### **4 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 finance skill and experience.

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

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

No, because if you were a director at the crucial point where it should have been clear that insolvent liquidation was inevitable, you could still be liable for wrongful trading.

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

## Directors' responsibilities:

### Avoiding the wrongful trading trap (continued)

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 2006 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.

#### 7 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.

#### 8 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.

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

No. 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.

#### 10 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 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.

### 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.

## Directors' responsibilities:

### Avoiding the wrongful trading trap (continued)

#### 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 January 2009 and may be affected by subsequent changes in the law. It should not be considered comprehensive.

Should you require further 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](mailto:james.partridge@ts-p.co.uk) or call him on 01892 701280.

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