SQUIRE PATTON BOGGS

Directors' Duties and Related Matters, in the Context of COVID-19

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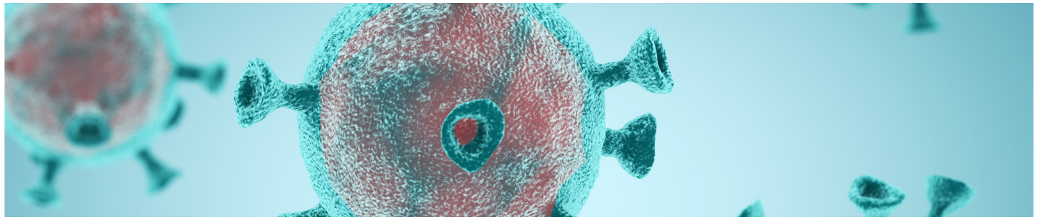
Scope And Purpose of This Note

This note summarises the duties that directors of companies incorporated in England and Wales are subject to.

This note explains those duties, and matters that directors should consider in relation to those duties, in the context of the developing coronavirus disease 2019 (COVID-19), commonly known as the "coronavirus" or simply, COVID-19, pandemic.

This note is not intended to, and does not in fact, constitute legal advice. Should you require legal advice in relation to your specific circumstances, please do not hesitate to contact one of our Restructuring & Insolvency team members, whose contact details are at the end of this note, who would be happy to assist you. Squire Patton Boggs (UK) LLP accepts no liability for any losses occasioned to any person by reason of any action or inaction as a result of the contents of this note.



Commentary

Directors' Duties

- Directors have statutory duties that they owe to the company. Each director owes these duties individually. In the exercise of those duties, generally and whilst the company trades solvently, the directors must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. Their statutory duties require that the directors also take into account wider factors such as the environment, employees, the standard of their business conduct, business relationships with suppliers and customers, and any other relevant circumstances
- If the company becomes insolvent, whilst these statutory duties are still owed legally to the company, they become subject to other interests to which the directors should have regard, such as those of the creditors of the company. However, the interests of the shareholders are still relevant.
- A breach of any of the statutory duties is actionable by the company, and any right of action could be exercised by an appointed insolvency practitioner should the company later enter a formal insolvency process.
- The law makes no distinction between executive and non-executive directors or shadow directors. All members of the board have the same duties to the company. A director must exercise reasonable care, skill and diligence. This means the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by a director in relation to the company **and** the general knowledge, skill and experience of that director.
- Whilst the interests of shareholders remain relevant during any period in which the company is, or may be, insolvent, the directors should not be influenced by any power any individual shareholder has to remove or replace the directors (or any of them) and must act in what they consider to be in the best interests of the company's creditors.

Trading Insolvently/Wrongful Trading

- A company is likely to be insolvent if:
  - It cannot meet all its present and due payment obligations (i.e. it is unable to pay its debts when they fall due), in which case, it is likely to be insolvent on a cash-flow basis, and/or
  - The value of its assets is less than the amount of its liabilities (taking into account its contingent and prospective liabilities), it is likely to be insolvent on a balance sheet basis
- Within these two tests of insolvency, there is much case law (recent and historic) beyond the scope of this note, setting out exactly what must be taken into account. However, in the current COVID-19 environment, it will, in many cases, be incredibly challenging (if not impossible) for businesses to accurately project their cash flow forecasts and/or value their assets for the purposes of the above tests. In those circumstances, directors should take a cautious approach on the solvency tests, and if in doubt, presume insolvency.
- Directors should be aware that whilst there is no statutory prohibition against trading whilst insolvent, there could be some degree of risk of the directors being required to personally contribute to the assets of the company if they continue to do so.
- If the directors continue to trade in circumstances where they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, then they may be liable for wrongful trading, under section 214 of the Insolvency Act 1986 (IA 1986).
- In such circumstances, the directors could be personally liable for any losses suffered by creditors caused by continued trading UNLESS they take **every** step possible with a view to minimising those losses that they ought to take.
- The key consideration for directors is, therefore: "Is there a reasonable prospect of avoiding insolvent liquidation?" If there is, the directors will not be liable for "wrongful trading" so long as they hold that belief reasonably, having regard to information available to them and the standards of skill and care expected of them
- The directors should, amongst other things, consider whether:
  - The company is presently operating within existing facilities whilst managing the position with creditors generally
  - The directors believe that the company qualifies for the UK Government's Coronavirus Business Interruption Loan Scheme (CBILS) or the Covid Commercial Financing Facility (CCFF)[1] and have received an indication from the company's bankers that they would support the company with those facilities
  - The directors believe that the company is eligible for any grants, rates relief or other support being made available by the UK government[2] in response to COVID-19
  - The company's financiers have withdrawn any facilities previously made available to the company (such as overdraft facilities) or have indicated that they will be unable to provide ongoing support
  - The UK government's decision to defer the latest quarter of VAT has a material positive effect on the company's cash-flows
  - The company is able to apply for a "time to pay" (TTP) arrangement with HMRC, to spread its current tax liabilities over a period of three to 12 months (given the indication from HMRC that it will be directing increased resources to enable it to process an increase in TTP requests)
  - The company is able to "furlough" employees (i.e. grant them a period of leave instead of making them redundant), given that the UK government will then pay 80% of the wage costs (capped at £2,500 per month) of those employees furloughed as a result of COVID-19[3]
  - Its shareholders have been made aware of any additional working capital requirements and have indicated a willingness to extend facilities to the company, and
  - There is a realistic prospect that the company can be sold as a going concern at a value sufficient to ensure all creditors will be paid in full, with a return to shareholders, and have instructed advisors to market the business; note that this is likely to be far less achievable in the current climate, compared to a non-COVID-19 impacted market
- The directors should be aware that there may be a risk of challenge to the directors' view if subsequently any assumptions that the directors were making relating to the above transpires to be materially inaccurate, particularly as a result of the fast-developing situation with COVID-19. If the company subsequently enters into an insolvency process, then the period of trading prior to that formal insolvency process will be reviewed by an insolvency practitioner with the benefit of hindsight. To mitigate against this risk, the following matters should be carefully and regularly reviewed during this period of uncertainty to ensure that, so far as possible:
  - Any new credit, supplies and services are necessary and *bona fide* for the purpose of continuing the business; if the business intends to take on further credit by way of the CBILS or CCFF, the directors should be of the view that the funding will enable the business to survive the pandemic and **continue on a business as usual basis once the pandemic recedes and normal trading patterns resume**; the directors should ensure that when applying for funds under the CBILS or CCFF, they provide full disclosure to its bankers regarding its financial position
  - Any transactions out of the ordinary course of trade are the subject of particular scrutiny and avoided wherever possible
  - No creditors are specifically preferred (see below) or transactions entered into at undervalue (see below) unless in good faith and that are critical to ensure the survival of the business and the prospects of achieving a turnaround and/ or solvent disposal/ restructuring
  - The directors work to develop expeditiously a credible business plan for the immediate term with as realistic and prudent assumptions as it is possible to make in the current circumstances, incorporating reasonably achievable options for a recovery for creditors and (if possible) a return to shareholders
  - The directors consider what contingency strategies could be put in place to protect the interests of creditors should the new business plan prove unsuccessful (see below)
  - The directors consider the net deficiency position of the company's assets immediately and analyses whether it is believed continued trading will either reduce or increase that deficiency; the directors should keep this under regular review with a comparative analysis of the net deficiency compared against what would be the position if continued trading had not occurred and regularly forecasted for a week in advance; this will provide supporting evidence that losses to the company were constantly under review and corrective action to reduce losses taken at an early stage; the analysis must show that any continued trading is intended to reduce the net deficiency of the company, but also that it is designed appropriately so as to minimise the risk of loss to individual creditors; this exercise should be further reinforced by circulating the net deficiency analysis to an insolvency practitioner each week for advice in respect of continued trading
- The directors should keep full and accurate board minutes of its reviews, decisions (including any dissenting views of individual directors), the reasons for those decisions and the information (particularly financial information which should be attached to the minutes) upon which such decisions are based.

1 Further detail can be found at https://www.businesssupport.gov.uk/coronavirus-business-support/.

2 See above link for further detail.

3 Further information can be found at https://www.businesssupport.gov.uk/coronavirus-job-retention-scheme/.

The Impact of COVID-19

- On 20 May 2020 the UK government published the Corporate Insolvency and Governance Bill that introduces temporary changes to the wrongful trading provisions under UK Insolvency Laws. The changes apply retrospectively from 1 March 2020 until at least 30 June 2020 – although this may be extended. The changes do not apply solely to companies impacted by the COVID-19 pandemic but to all companies (save for some exceptions such as building societies and banks).
- Under the temporary provisions, when determining whether a director is liable to make a contribution to the assets of a company for wrongful trading, the courts has to assume that a director is not responsible for any worsening of the financial position of the company, although this does leave open the possibility that the assumption can be rebutted,
- This measure should enable businesses to continue to operate and/or to be mothballed through this turbulent period without creating additional unnecessary risks for directors, encouraging companies to take advantage of the unprecedented financial support offered by the UK government to help support cash flow if the directors reasonably believe that this is in the best interests of the company/creditors. Whilst the changes to the wrongful trading provisions provide comfort to directors who were concerned about incurring additional credit or borrowings, directors should still proceed on the basis that they need to comply with the wrongful trading provisions as set out above. The changes (once enacted) are only temporary, are based on an assumption and the time period can be curtailed. However, in all probability with far more leniency being shown, provided directors have properly evaluated and documented their decisions and they are reasonable in all the circumstances the likelihood of liability for wrongful trading appears to be significantly reduced.
- With that in mind, if directors cannot satisfy themselves on the points listed under trading insolvently/wrongful trading, to mitigate against any risk, they should at the very least:
  - Ensure that they monitor UK government advice that impacts their business and any new or amended UK government financial support that is made available
  - Ensure that they monitor the progress of the new bill in relation to wrongful trading and be aware of how any changes prior to enactment may impact their business
  - Seek professional advice at the earliest opportunity, in particular whether it will be appropriate to "mothball" the business until the COVID-19 pandemic allows businesses to trade on something approaching a business as usual basis
  - Refrain from entering into transactions that are not in the ordinary course of their business, and
  - Minimise their outgoings and preserve cash as best they can

Possible Redundancies

- The directors should consider at an early stage whether redundancies to the company's workforce may be necessary in order to save the business, and if so, whether consultation is required pursuant to TULRCA.
- If the business is contemplating redundancies, but only because of the impact of COVID-19 on the business, they should also consider whether it is instead preferable to "furlough" those employees that would otherwise have been made redundant, given that the UK government will contribute 80% of those employees' wage costs (subject to a £2,500 per month cap per employee).
- Under section 188 of TULRCA, there is an obligation on the company to inform and consult appropriate representatives of affected employees when redundancies of 20 or more employees are being proposed to take effect in a period of 90 days or less. The appropriate representatives of affected employees are either trade union representatives, where a trade union is recognised or where no trade union is recognised, employee representatives elected for the purposes of consultation. The directors should consider whether any trade unions are recognised, and if not, what steps will need to be taken for employees' representatives to be elected to effect collective consultation. Consultation must last for a minimum of 30 days, where 20 – 99 redundancies are proposed (or at least 45 days if 100 or more redundancies are proposed) prior to any dismissals taking effect.
- For completeness, where an employer proposes to dismiss fewer than 20 employees within a 90-day period, there is no requirement to collectively consult with representatives of affected employees. However, an employer is still required to follow a fair procedure if they wish to avoid a finding of unfair dismissal.
- Under section 193 of TULRCA, there is an obligation on the company to notify the Secretary of State (currently via the Department for Business, Enterprise and Industrial Strategy, BEIS) in writing using form HR1 in a collective redundancy situation. Again, notification is to be received by BEIS at least 45 days before the first dismissal takes effect, where the company is proposing to dismiss 100 or more employees. That notification period is reduced to at least 30 days when the company proposes to dismiss between 20 and 99 employees.
- The directors should keep full and accurate minutes of its proposals, and in respect of decisions taken to make any employees redundant, ensure that consideration has been given to the company's obligations to collectively consult and to notify the Secretary of State. In the case of the collapse of parcel delivery firm City Link Limited, the directors were heavily criticised for not notifying the Secretary of State, and a prosecution was initially brought against the directors for not notifying the Secretary of State. Whilst the City Link directors were eventually acquitted based on the narrow facts of that case, there is a real risk that directors who are proposing to make redundancies could be prosecuted for failing to notify in the event of any delay in doing so. The directors may even wish to notify the Secretary of State as a protective measure. Whilst it remains to be seen how strictly this requirement will be enforced in the current circumstances, directors should continue to comply with the notification provisions to avoid risk of prosecution.

Contingency Strategy

- Given the current severe restrictions placed upon businesses in the UK and the economic conditions as a result of the pandemic, directors should immediately consider what steps they should be taking in order to protect the business. A number of businesses in these circumstances will be at risk of trading whilst insolvent (and may be in real difficulty in assessing the company's financial position, given the dramatic impact caused to cash-flows, trading and the value of assets). The directors will need to take every step to minimise losses to creditors. This does not necessarily mean an immediate cessation of trading (unless the business has been ordered to do so by the UK government), but a number of businesses are likely to need to "mothball" during this period and we would recommend taking urgent further advice on the options available to the business.

Challengeable Transactions

- **General**

  Certain transactions that take place at a time when a company is insolvent, or becomes insolvent as a result of the transaction, are open to challenge by an appointed insolvency practitioner if the company subsequently enters a formal insolvency procedure.

  Directors, to the extent responsible for such transactions, can be held personally liable for any loss suffered by the company as a result of the transaction, both under IA 1986 and as a potential misfeasance.

  Directors should be aware of the grounds for such challenges and, in considering any relevant transactions, determine whether it is appropriate for such transactions to proceed. Any such decisions should be carefully minuted.

- **Transactions at Undervalue (s 238 IA 1986)**

  A transaction will be at an undervalue (within the meaning of IA 1986) if it is a gift by the company, or the company receives no consideration, or the value of the consideration received by the company (in money or money's worth) is significantly less than the value of the consideration given by the company in the transaction. It will be challenging in the current circumstances to value certain classes of assets accurately, but directors should keep records of the basis on which the disposed asset was valued, and why.

  Any such transactions taking place within two years of formal insolvency will be open to challenge, provided they took place at a time the company was insolvent or became insolvent as a result of the transaction (which is presumed if the transaction was with a connected party).

  However, the transaction will not be capable of challenge if:

  – It was done in good faith for the purpose of carrying on the business, and

  – The directors had reasonable grounds for believing that it would benefit the company

Therefore, in considering any asset disposals to raise liquidity (for example) at less than market value, the directors should address specifically whether it is justifiable on the grounds set out above. We recommend specific advice is taken in relation to any relevant transaction, and the decision is carefully minuted at the time.

- **Preferences: (s 239 IA 1986)**

  A preference is a transaction with a creditor (or a surety or guarantor of any of the company's liabilities) under which the creditor is placed in a better position than it would have been in if the transaction had not occurred and the company proceeds into insolvent liquidation.

  A preference is open to challenge if the company proceeds into formal insolvency within six months of the transaction in question, if the creditor is not a connected party, and within two years if the creditor is connected. This is provided the company was insolvent at the time, or became insolvent as a result of the transaction (which is presumed if the creditor is connected).

  However, in effecting the preference, the company must have been influenced by a desire to give the creditor the preferential position. This is presumed for transactions with connected creditors, but can be rebutted.

  In circumstances where decisions have to be made on a daily basis during cash flow difficulties as to which creditors to pay, preference issues are highly relevant. In this regard, the directors should consider the following:

  – Is the payment necessary for the continued operation of the business, and, therefore, necessary to preserve the prospects of a going concern survival and payment in full to creditors, i.e. **is it business critical**? This may include payment to key suppliers of goods and/or services where such supplies are critical and cannot easily be resourced elsewhere at the speed and price required. Consideration should be given as to whether payment over time for historical debt can be agreed as a condition of continued supply.

  – Is the payment necessary to avert action being taken by the creditor which may prejudice the survival of the business? If payment is made under threat of winding up proceedings, or legal proceedings that the company cannot defend or afford to defend, or to avoid distraint on goods, it is unlikely to be considered a preference. Evidence of this threat and the company's response should be documented.

- **Directors' Remuneration, Expenses and Employees**

  – As connected creditors of the company, particularly careful attention should be paid to discharging outstanding expenses claims and arrears of remuneration to directors. If the company is continuing to trade on the basis that the directors hold a reasonable belief that the company will avoid insolvent liquidation and pay all creditors in full, it would be questionable as to their intentions if, at the same time, significant arrears of expenses and remuneration are discharged when other creditors are not being paid.

  – Employees, on the other hand, will be a necessary part of continuing to operate the business. As directors under a contract of employment are employees and a critical requirement to ensure the company is managed through this phase, ongoing payments of remuneration and expenses (and general payroll) may be appropriate to ensure continued services to the company. This is subject to any requirement identified in the business plan to effect employee cost reductions, in particular those resulting from the "furloughing" of employees, to take advantage of the UK government underwriting 80% of the employment costs of those furloughed employees. Payment of arrears of remuneration and expenses claims may be justifiable in the circumstances; if not, to do so would cause genuine financial hardship for the director personally such that the director could not continue with their responsibilities without seeking an alternative source of income. If such circumstances exist, any such director should consider taking independent advice on their personal position if the directors as a whole consider such payment cannot be made presently within the resources available.

- **Unpaid National Insurance Contributions (NIC)**
  - If a company does not pay the correct amount of NIC, HMRC has the power under s121C of the Social Security Administration Act 1992 to issue Personal Liability Notices to recover the unpaid NIC plus interest and penalties from the directors or any other officers personally. Before issuing a notice, HMRC must be satisfied on the balance of probabilities that the failure to pay was due to fraud or neglect, judged by an objective test.
  - HMRC will consider issuing a notice where, in the face of persistent failure to pay NIC, a company made significant and/or regular payments to other creditors, connected persons or companies, or in the form of directors' salaries.
- **Offences Under the IA 1986**

  The directors should be aware that since 1 October 2015, the right to bring claims for certain offences under the IA 1986, including Fraudulent Trading and Wrongful Trading, has been extended to an Administrator and/or can now be assigned by an appointed insolvency practitioner (i.e. either a Liquidator or Administrator). For the sake of completeness, we set out below a summary of the other main offences that will be investigated by the appointed insolvency practitioner in the event that the company proceeds into formal insolvency:
  - Fraudulent Trading: (s213 IA 1986)

    It is an offence to knowingly carry on the business of a company with intent to defraud creditors and any person who does so may be ordered by the court to make such contributions to the company's assets at it thinks fit.
  - Misfeasance or Breach of Fiduciary Duty: (s212 IA 1986)

    It is an offence for a director of a company to have misapplied or retained or become accountable for any money or other property of the company or been guilty of an misfeasance or breach of fiduciary duty in relation to the company allowing the court to order the director to repay, restore or account for the money or property together with interest or contribute to the company's assets by way of compensation.

Director Disqualification

- Where a company proceeds into formal insolvency, the appointed insolvency practitioner has a duty to report to the Secretary of State on the conduct of each of the directors and former directors of the company. The Secretary of State must then decide whether to bring proceedings against the directors to disqualify any of them from acting as a director or in the promotion, formation or management of any company on the grounds of unfitness, for between two to 15 years.
- The directors should, therefore, be aware that should it not prove possible ultimately to effect a solvent turnaround and/or disposal, and the company proceeds into formal insolvency, their conduct as directors (particularly at this time and going forward) will be subject to such scrutiny
- It is, therefore, critically important for this reason, and to deal with risks in relation to all the matters raised in this note, that the directors regularly (i.e. at least weekly, and preferably every few days during the pandemic) review the ongoing financial position and progress of the business plan, any relevant transactions for which particular consideration should be given, and its continuing belief in the appropriateness of continuing trading (or continuing to "mothball", as applicable).

  All such reviews should be carefully minuted, to include the information available to the directors, matters discussed, all views expressed and considered, any decisions reached and the rationale for such decisions having regard to the points and recommendations made in this note. The directors should also keep a notebook of daily discussions and matters, so that there is always a contemporaneous note to support the directors' actions in the conduct of the business during this time.

Personal Guarantees

The directors should be aware that any directors who have given personal guarantees may be personally liable for the company's debts under them.

Deposits and Trust Accounts

- There is no case law or statutory authority that states, in the company's present circumstances, the directors are under a duty to protect deposit creditors by the operation of a trust account to "ring-fence" deposit monies.
- Moreover, there is case law authority that highlights the risk of a preference in creating a trust for such creditors and using company funds to place monies into a trust account for this purpose. Further, within the context of director disqualification, the courts have held that where directors are pursuing a reasonable prospect of avoiding an insolvent liquidation and a full return to all creditors, there is no legal obligation to depart from normal trading practice so as specifically to protect deposits and pre-payments by a trust account.
- However, where there is uncertainty regarding the current position, we do not believe the directors could be criticised for seeking to protect deposits received going forward by the operation of a properly constituted trust account, but would make the following comments:
  - At the time of receipt of the deposit, it must be paid on an express trust obligation (or on terms that evidence a trust) such that the deposit is properly held on trust. This would require clear terms and conditions with such customers to this effect (which we would be happy to assist with) and making sure operational practices are in place to ensure those terms apply. Even if deposits have been received, and placed in a separate account, there would remain a preference risk if the account is not properly constituted as a trust account to avoid the fund being regarded as an asset of the company.
  - By placing deposits on trust, this would reduce the working capital available to the company with which to pursue a recovery strategy which protects all creditors and a return for shareholders, thereby shortening the time available to achieve this.
  - If, in light of these comments, the directors who elect not to proceed with arrangements for placing deposits on trust, we would nevertheless recommend that an account be set up or kept open (as applicable) for that purpose should it prove necessary in due course to proceed. In the meantime, the directors should take care not to actively encourage higher levels of deposits than would ordinarily be experienced to avoid any criticism in that regard.
- Should, however, the company be at risk of trading whilst insolvent, we believe the courts are likely to consider placing deposits on trust as a step which "ought to be taken" to minimise losses to creditors.

Restriction on the Use of Company Names: (s 216 IA 1986)

- In the event that the directors wish to consider a management buyout from insolvency practitioners, they should be aware that it is an offence for a director or shadow director of a liquidated company to be involved either directly or indirectly with a new company with a similar name to the liquidated company for a period of five years beginning with the day on which the company went into liquidation. If a director breaches this provision, the penalties include imprisonment, a fine or both, together with personal liability for the debts of the new company.
- However, there are specific circumstances in which the above section will not apply and we can advise you further if required.

Contacts

John Alderton
Partner, Leeds
T +44 113 284 7026
M +44 788 505 8896
E john.alderton
@squirepb.com

Russ Hill
Partner, Birmingham
T +44 121 222 3132
M +44 792 160 0409
E russell.hill
@squirepb.com

Susan Kelly
Partner, Manchester
T +44 161 830 5006
M +44 774 092 4773
E susan.kelly
@squirepb.com

Devinder Singh
Partner, Birmingham
T +44 121 222 3382
M +44 772 139 9625
E devinder.singh
@squirepb.com

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