Litigation risk in the post-Covid world: steering the ship on stormy seas

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Articles | Published on 26-Aug-2021 | United Kingdom

This feature article discusses how businesses that are in financial distress can manage the risks associated with litigation brought against them, as claims of all kinds are expected to rise in the wake of the COVID-19 pandemic.

Speedread

Businesses that are facing financial distress in the wake of the COVID-19 pandemic need to manage the risks associated with litigation that could be brought against them. Directors must comply with the general duties owed to the company, as specified in sections 171 to 177 of the Companies Act 2006 (2006 Act). These include exercising independent judgment, acting to promote the success of the company, and exercising reasonable care, skill and diligence. Former directors also continue to be subject to duties under the 2006 Act.

A director, past or present, may face personal claims against them for, among other things, negligence and breach of duty. These claims will be brought by an insolvency practitioner should the company become insolvent. The counterparties to the company's transactions, including suppliers and possibly also purchasers, will be involved in their capacity as creditors.

Claims for misrepresentations may be made by third parties against the company. Claims for fraudulent misrepresentation may be made by third parties or by the insolvency practitioner against the directors who will be personally liable for their fraudulent misrepresentations.

Transactions that occurred when the company was insolvent or that led the company to become insolvent are open to challenge by the appointed insolvency practitioner. Directors could be liable for wrongful trading and be held personally liable to contribute to the company's assets an amount equivalent to the losses suffered by creditors for continued trading. There is also the risk of fraudulent trading and being held liable to make whatever contributions, if any, to the company's assets as the court thinks proper. Transactions at an undervalue and preferences could also be subject to challenge. Directors should keep careful records of their considerations and ultimate decisions.

If a director has misapplied or retained or become accountable for any money or other property of the company or been guilty of a misfeasance or breach of fiduciary duty in relation to the company, the court may 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. Significant arrears of directors' expenses and remuneration should not be discharged while other creditors go unpaid. However, ongoing payments of remuneration and expenses to directors and general payroll to employees may be appropriate.

Where a company proceeds into formal insolvency, the directors could be disqualified from acting as a director for up to 15 years. If there is any suggestion that a dividend could be in excess of available distributable profits, it may be unlawful and directors could be personally be liable to repay the company for any loss suffered.

If redundancies are being contemplated, directors should consider furloughing employees, while the furlough scheme is still open. Directors must follow the correct procedures in any redundancy process, for example as to collective consultation, to avoid risk of prosecution.

Increased levels of litigation concerning businesses of varying sizes and issues such as refinancing, debt claims and insolvency are anticipated in the near term. When a company is in financial distress, it is important for directors to demonstrate that they have followed financial due diligence and compliance to protect the company and themselves against personal liability, criminal sanctions and legal claims.

Directors face a difficult task trying to steer the ship in torrid financial circumstances. Desperate times may lead to desperate decisions. The tipping point for a company in financial difficulty will be an objective one to assess. This article sets out the steps that directors, in particular chief financial officers, can take in collaboration with their company's general counsel and CEO to manage these risks and protect their business, especially when dealing with suppliers or buyers. If in doubt, directors must ensure that they document their decision paths and, if necessary, rely on professional advice.

DIRECTORS' DUTIES

The general duties specified in sections 171 to 177 of the Companies Act 2006 (2006 Act) are owed by a director to the company. The law does not differentiate between executive and non-executive directors, or between shadow and de facto directors.

Exercising powers

A director must:

- Act in accordance with the company's constitution and exercise powers only for the purposes for which they are conferred (*section 171, 2006 Act*).
- Exercise independent judgment (*section 173, 2006 Act*).

Promoting success

A director must act in the way that 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 (*see box "Section 172 compliance"*). In doing so, they should have regard, among other matters, to:

- The likely consequences of any decision in the long term.
- The interests of the company's employees.
- The need to foster the company's business relationships with suppliers, customers and others.

- The impact of the company's operations on the community and the environment.
- The desirability of the company maintaining a reputation for high standards of business conduct.
- The need to act fairly as between members of the company (*section 172, 2006 Act*).

Where the company is insolvent, the director must also have regard to the interests of the company's creditors. This obligation applies generally when the company is in financial difficulties and can kick in where the creditors' money is at risk; the company does not have to be technically insolvent on a balance sheet or cash flow basis.

Care, skill and diligence

A director of a company must exercise reasonable care, skill and diligence (*section 174, 2006 Act*). This is assessed both objectively and subjectively, and means the care, skill and diligence that would be exercised by a reasonably diligent person with:

- The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company.
- The general knowledge, skill and experience that the director has.

Information. Directors must ensure that they receive the information that they need in order to carry out their roles and satisfy their duties. The board has oversight duties in relation to compliance so the directors will need to ensure that the quality and frequency of the management information that they receive is adequate. The directors will need to ensure that the company's compliance policy responds to the company's risk profile and risk assessments, and that the procedures put into place remain fit for purpose. The directors will need to make a judgment call as to the detail and frequency of the information that they require.

Where the information provided to the board is legally privileged, the group to whom it is disseminated must be considered as well as how any advice is reflected in the minutes.

Advisers. Directors must be satisfied that they have a proper understanding of their functions and duties, the fundamental principles of company law, the company's business, the risks faced by the company and the regulatory and compliance regime in which it operates. They should receive any necessary training to keep their knowledge, skills and experience up to date. Of course, they can rely on the expertise of their colleagues and advisers and a failure to do so may amount to a breach of the duty. In *Re Duomatic Ltd*, for example, a director had a defence to a charge of breach of duty if the matter was ratified by the unanimous vote of the shareholders (*[1969] 2 Ch 365; see Briefing "The Duomatic principle: informal shareholder decision making"*). Seeking advice does not reduce or remove the duty of a director to supervise the discharge of delegated functions.

Conflicts of interest

A director of a company must avoid a situation in which they have, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company (*section 175, 2006 Act*) (section 175). This applies especially to the exploitation of any property, information or opportunity. If the conflict has been authorised in advance and this is permitted in the company's constitution, then this will not breach the duty under section 175. In order to authorise the conflict, the relevant meeting must be quorate without counting any interested directors and the authorisation must be given without counting their votes. Directors must give full disclosure of the scope and nature of the conflict for the authorisation to be effective.

Benefits from third parties

A director of a company must not accept a benefit from a third party conferred by reason of being a director for doing, or not doing, anything as director (*section 176, 2006 Act*). A "third party" means a person other than the company, an associated body corporate or a person acting on behalf of the company or an associated body corporate. This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

Declaring interests

If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, they must declare the nature and extent of that interest before the company enters into the transaction or arrangement (*section 177, 2006 Act*). The declaration may, but need not, be made at a meeting of the directors, or by notice to the directors. If a declaration of interest proves to be, or becomes, inaccurate or incomplete, a further declaration must be made.

Continuation of duties

Former directors continue to be subject to the duty to avoid certain conflicts of interest as regards the exploitation of any property, information or opportunity of which they became aware when they were directors (*170(2)(a), 2006 Act*). The High Court recently considered this duty in *Alan Burnell v Trans-Tag Limited, Robert Aird* (*[2021] EWHC 1457 (Ch)*). The question was whether a claim could be founded where a former director had left office for reasons not connected with the relevant opportunity and they subsequently pursued the opportunity having left office. The court held that conduct of a director after resigning from office can give rise to a breach of the continuing section 175 duty, and that it is not a requirement that a director's resignation must have been prompted or influenced by the director's wish to exploit an opportunity belonging to the company. *Burnell* marked a change from the pre-2006 Act common law cases, which were based on the principle that the fiduciary obligations expired with the fiduciary relationship (*Foster Bryant Surveying Limited v Bryant and others [2007] EWCA Civ 200; www.practicallaw.com/7-314-1961*).

Recent cases have confirmed the continuation of a director's general duties under sections 171 to 177 of the 2006 Act. In *Re Systems Building Services Group Ltd (in Liquidation)*, the High Court confirmed that while the powers of a director cease on a company entering administration or liquidation, their duties continue (*[2020] EWHC 54 (Ch); www.practicallaw.com/w-024-1470*). In *Re Systems Building Services Group*, the sole director of the company bought a property at a substantial undervalue from the company days after the company went into administration.

The British Virgin Islands (BVI) courts have also recently held that a director's fiduciary duties can still apply, even after they have resigned. In *Byres v Chen,* a former director was found to have breached her duties by authorising payments to a creditor at a point when she knew the company could not avoid insolvency (*[2021] UKPC 4*). While a decision of the BVI court is not binding on the courts of England and Wales, they may find the decision persuasive.

Claims against directors

A current or former director may face personal claims for, among other things, negligence, breach of duty, default or breach of trust.

Breach of duty cases are common and claims for breach are often combined with other causes of action, such as, fraudulent and wrongful trading. Breach of duty cases are often easier to prove from an evidence perspective. From a director's perspective, thankfully, the courts are unlikely to intervene if the directors were acting in good faith, irrespective of their bad business decisions, providing that they do not overstep the mark.

In *Southern Counties Fresh Foods Ltd, also known as Re Cobden Investments Ltd v RWM Langport Ltd*, the court held that what constitutes success will be for the director's good faith judgment (*[2009] EWHC 1362 (Ch)*). This ensures that business decisions on, for example, strategy and tactics, are for the directors and not subject to decision by the courts, provided that the directors were acting in good faith.

In *Re Saint George Investment Holdings Ltd Manolete Partners plc v Matta and others*, a director's loan account was overdrawn by £1.3 million before the company entered into administration (*[2020] EWHC 2965 (Ch)*). The director had withdrawn funds to, among other things, finance the purchase and maintenance of his personal yacht. An application was subsequently made by an insolvency litigation funding company for declarations and orders under sections 238 and 239 of the Insolvency Act 1986 (1986 Act) and sections 171 to 176 of the 2006 Act.

The court held that a director's powers to authorise payments from a company's funds are not granted in order to enable directors to pay for or fund very significant personal items of expenditure on a long-term basis. The director was therefore in breach of his duties under the 2006 Act and his argument that the company was able to afford the payments was irrelevant.

Directors will be relieved to hear that they may have a defence if they acted honestly and reasonably, and that this defence may relieve them of liability in whole or in part (*section 1157, 2006 Act*). This defence is not available in cases of fraud where the director's dishonesty is at the heart of the allegations of breach of duty.

It is the authors' view that, in the aftermath of the COVID-19 pandemic, directors are most likely to face claims for wrongful, and possibly also fraudulent, trading, transactions at an undervalue and preference transactions (*see "Transactions at an undervalue" and "Preferences" below*). These claims will be brought by an insolvency practitioner should the company become insolvent. The counterparties to the company's transactions, including suppliers and possibly also buyers, will be involved in their capacity as creditors. The company or an insolvency practitioner may bring claims for payment of unlawful dividends.

Claims for misrepresentations may be made by third parties against the company. Claims for fraudulent misrepresentation may be made by third parties, such as individual unsecured creditors, or by the insolvency practitioner against the directors who will be personally liable for their fraudulent misrepresentations. In *Contex Drouzhba Ltd v Wiseman and another*, a company director who signed a supply contract specifying payment obligations by the company made an implied representation that the company was able to make payment, which he knew was unlikely to be true (*[2006] EWHC 2708 (QB)*). The director was jointly liable with the company in the tort of deceit. Since his liability was based on fraud, he was not able to evade personal liability by sheltering behind the separate legal personality of the company.

TRADING INSOLVENTLY

In the uncertainty of the current COVID-19 pandemic business climate, the risk of insolvency for most industries is heightened (*see box "Measures introduced in response to the COVID-19 pandemic"*).

A company is likely to be insolvent if it is:

- Insolvent on a cash flow basis; that is, it is unable to meet its present and due payment obligations.
- Insolvent on a balance sheet basis; that is, the value of its assets is less than its liabilities, including contingent and prospective liabilities, at a given time.

At present, it is very difficult for businesses to predict their cash flow forecasts or value their assets accurately. In assessing solvency, directors should therefore proceed cautiously and, if in doubt, presume insolvency (*see box "Minimising the risks of insolvent trading"*). This is because if a company enters a formal insolvency procedure, transactions that occurred when the company was insolvent or that led the company to become insolvent are open to challenge by the appointed insolvency practitioner.

Wrongful trading

Under section 214 of the 1986 Act (section 214), if a director knew or ought to have concluded (at some point before the commencement of the winding up of the company) that there was no reasonable prospect that the company would avoid going into insolvent liquidation, they may be liable for wrongful trading. In *Re DKG Contractors Ltd*, once the directors knew that a creditor had refused further supplies because of lack of payment and that other creditors were demanding payment, the High Court held that they should have introduced some financial controls (*[1990] BCC 903; www.practicallaw.com/8-100-5601*). The directors were therefore liable for wrongful trading from that time, even though their knowledge, skill and experience was described by the court as hopelessly inadequate.

The court, on the application of the liquidator, may declare that the director is personally liable to contribute to the company's assets an amount equivalent to the losses suffered by creditors for continued trading. This is unless one of the following applies:

- Having regard to information available to them and the standards of skill and care expected of them, there was a reasonable prospect of avoiding insolvent liquidation.
- The director takes every step possible to minimise the potential loss to the company's creditors (*section 214(3) and (4)*).

The onus in establishing the defence under section 214(3) is on the director; it is not for the liquidator to establish that the director had not taken the necessary steps (*Philip Anthony Brooks and Julie Elizabeth Willetts (Joint Liquidators of Robin Hood Centre Plc) v Keiron Armstrong and Ian Walker* (*[2015] EWHC 2289 (Ch); www.practicallaw.com/9-618-8548*).

Liability only arises under section 214 if, on a net basis, it is shown that the company is worse off as a result of the continuation of trading (*Re Marini Ltd (the liquidator of Marini Ltd v Dickenson and others) [2003] EWHC 334; www.practicallaw.com/4-102-3541*). The High Court outlined its position on the quantum of a director's liability for wrongful trading under section 214(1) and the scope of the defence under section 214(3) as follows:

- The court will measure the increase in the company's net deficiency of assets over the relevant period; that is, from the time when the directors first realised (or ought to have done so) that there was no reasonable prospect of the company avoiding an insolvent liquidation up to the time when the company went into insolvent liquidation.
- The court will not make any order if, over the relevant period, there is no increase in the net deficiency of the company's assets. If there is an increase in the net deficiency of assets over the period, the maximum quantum of any liability for wrongful trading will be the amount of that increase.
- The availability or otherwise of the defence under section 214(3) that the director took every step with a view to minimising the potential loss to creditors will depend on the loss, or disproportionate loss, caused to individual creditors. In *Grant and another v Ralls and others (Re Ralls Builders Ltd)*, the court held that if directors succeed in reducing the net deficiency of the company as regards its general body of unsecured creditors, they are not entitled to an outright defence under section 214(3) because the manner in which they chose to continue trading meant that the bank and some of the existing unsecured creditors were paid at the expense of new creditors who ended up not being paid (*[2016] EWHC 243 (Ch)*).

Fraudulent trading

Trading is fraudulent if, during the winding up of a company, any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose. The court, on the application of the liquidator, may declare that any persons who were knowingly parties to the fraud are to be liable to make whatever contributions, if any, to the company's assets as the court thinks proper (*section 213, 1986 Act*).

It is not sufficient to show that the company continued to run up debts when the directors knew that it was insolvent. There must be actual dishonesty, involving real moral blame (*Re Patrick and Lyon Ltd [1933] Ch 786*). Anyone who is knowingly party to carrying on the business with intent to defraud may be liable for fraudulent trading. In *Bank of India v Morris*, the Court of Appeal held that a bank was a party to fraudulent trading by virtue of its employee's knowledge (*[2005] EWCA Civ 693*). It was not necessary that those persons knew the details of the fraud, but rather that they knew that a fraudulent activity was taking place with a view to defrauding someone or for a fraudulent purpose. To disassociate themself from the fraud, the defendant must demonstrate a legitimate lack of knowledge that the fraud was occurring and show that they did not turn a wilful blind eye to the actions.

Where more than one person is liable for fraudulent trading, the court should apportion liability between the defendants by reference to the degree of control that each party had over the company's affairs and the benefit, if any, that each party obtained from the fraudulent trading (*Goldfarb v Higgins and others (no 2) [2010] EWHC 613 (Ch); www.practicallaw.com/8-502-1183*).

Transactions at an undervalue

A transaction, which may include informal arrangements and procuring acts by third parties, will be at an undervalue if either of the following applies:

- It is a gift by the company or the company receives no consideration.
- 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 (*section 238(4), 1986 Act*).

The transaction will not be subject to 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 (*section 238(5), 1986 Act*).

In *Phillips v Brewin Dolphin Bell Lawrie Ltd*, the court held that where an application to set aside a transaction at an undervalue is brought, it is for the applicant to satisfy the court as to the value and deficiency of the consideration provided to the insolvent company (*[2001] UKHL 2; www.practicallaw.com/3-101-4108*).

Directors should keep records of the basis on which an asset was valued and why. If an asset is to be disposed of for less than market value, the directors should first consider whether this is justifiable, obtain specific advice on the transaction and minute carefully the details of their considerations and ultimate decision. Transactions that occurred within two years of formal insolvency can be challenged if they took place when the company was insolvent or became insolvent as a result of the transaction, which is presumed if the transaction was with a connected party. A connected person is a director, shadow director or an associate of a director, shadow director or the company.

In *Biscoe and Baxter as Joint Liquidators of Equitable Law Capital Limited v Milner*, the court found that the company's continued trading had caused an increase in the deficit to creditors and that one of the respondents, who was alleged to be a de facto director, was therefore liable for wrongful trading (*[2021] EWHC 763 (Ch)*). As that respondent knew from the outset that the scheme that the company was running was dishonest and fraudulent, he was also liable for fraudulent trading. He was also in breach of his director's duties, and payments received by him from the companies were transactions at an undervalue. Payments made to an insurance broker as part of the fraudulent scheme were not held to be transactions at an undervalue by the court, as those transactions took place at freely negotiated market prices.

The court in *Akhmedova v Akhmedov* confirmed that section 423 of the 1986 Act (section 423), which deals with transactions defrauding creditors, has extensive international reach to assets outside the jurisdiction of England and Wales (*[2021] EWHC 545 (Fam)*). The court also confirmed that transactions at an undervalue do not need to result in the debtor's insolvency in order for section 423 to apply.

Preferences

A company gives a preference if it does anything or suffers anything to be done that has the effect of putting one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities into a better position in the event of the company going into insolvent liquidation than they otherwise would have been in (*section 239(4), 1986 Act*). This was the case in *Re CGL Realisations Ltd*, where Kesa Holdings Limited entered into an agreement to sell its shares in Comet to Hailey Acquisitions Limited. Before the sale, Comet had been using a revolving credit facility provided by Kesa Holdings (*[2020] EWHC 1707 (Ch)*). On 3 February 2012, the date of completion of the sale, Comet repaid £115.4 million owing under the credit facility.

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 by evidence (*section 239(5) and (6), 1986 Act*).

A preference can be challenged if the company goes 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 that the company was insolvent at the time or became insolvent as a result of the transaction, which is presumed if the creditor is connected.

When deciding which creditors to pay, directors should consider whether:

- The payment is necessary for the continued operation of the business. These payments may include key suppliers of goods or services where the supplies are critical and cannot easily be resourced elsewhere at the speed and price required.
- Payment is necessary to prevent action being taken by the creditor, such as winding up proceedings or legal proceedings, which may prejudice the survival of the business. Evidence of any threats by creditors and the actions of the company in response should be carefully documented.

Deposits and trust accounts

There is a risk of granting a preference if a company creates a trust account containing company funds to protect deposit creditors. There is no legal obligation to depart from normal trading practice to protect deposits and prepayments by a trust account.

In order that the deposit is properly held on trust so that the fund will avoid being regarded as an asset of the company and therefore a preference risk, it must be paid on an express trust obligation or on terms that evidence a trust. This requires clear terms and conditions to be agreed with customers and for operational practices to be in place to ensure that those terms apply.

An account should be set up or kept open, as applicable, for the purpose of placing deposits on trust, should it prove necessary in due course. 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.

Misfeasance or breach of fiduciary duty

If a director of a company has misapplied or retained or become accountable for any money or other property of the company or been guilty of a misfeasance or breach of fiduciary duty in relation to the company, the court may 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 (*section 212, 1986 Act*).

Remuneration and expenses

It would be improper if significant arrears of directors' expenses and remuneration were to be discharged while other creditors went unpaid. However, ongoing payments of remuneration and expenses to directors and general payroll to employees may be appropriate to ensure continued services to the company.

National Insurance

HM Revenue & Customs can issue personal liability notices to recover unpaid National Insurance contributions together with interest and penalties from directors personally, especially where a company made significant or regular payments to other creditors, connected persons or companies, or in the form of directors' salaries (*section 121C, Social Security Administration Act 1992*).

Director disqualification

Where a company proceeds into formal insolvency, the appointed insolvency practitioner has a duty to report to the Secretary of State (SoS) on the conduct of each of the directors and former directors of the company. The SoS 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 (*section 6(4), Company Directors Disqualification Act 1986*).

Company names

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 for a period of five years beginning with the day on which the old company went into liquidation (*section 216, 1986 Act*). 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.

Unlawful dividends

A director who authorises the payment of a dividend that contravenes the provisions of the 2006 Act may be in breach of their duties and may personally be liable to repay the company for any loss suffered, even if they are not a shareholder.

If there is any suggestion that a dividend could be in excess of available distributable profits, it may be unlawful. If in doubt, the business must obtain accountancy advice before authorising dividend payments.

To avoid litigation in this regard, directors should prepare evidence that:

- The figures relied on when deciding the amount of the dividend can be justified.
- The company has sought advice from the company's accountants.
- The company has presented to the executive and non-executive board of the company the proposed dividend amount for approval.

In *Burnden Holdings (UK) Ltd v Fielding*, Burnden had demerged to separate its energy consulting business into a separate corporate group (*[2019] EWHC 1566 (Ch); www.practicallaw.com/w-021-3658*). There was a distribution of shares in Burnden's subsidiary, Vital, to Burnden's shareholders. The majority shareholders were also Burnden's directors. The distribution was made by reference to interim accounts.

The court held that if directors knew the facts that constituted an unlawful distribution, they will be liable to reconstitute the company's assets irrespective of whether they knew that the distribution was unlawful. If directors are unaware of the facts that rendered the distribution unlawful, then provided that they have taken reasonable care to secure the preparation of accounts, they will not be liable if there are insufficient profits for that purpose.

Directors are entitled to rely on the opinion of others, including management and lawyers, as to the accuracy of statements appearing in the company's accounts. They are not expected to have the same level of expertise as professional advisers in a specialist area.

In *Bairstow v Queen's Moat Houses plc*, Bairstow, former directors of the Queen's Moat Houses plc, appealed against an order that they pay £26.7 million, which had been unlawfully distributed by way of dividend (*[2001] EWCA Civ 712*). The amount of the dividend paid had exceeded the amount of Queen's Moat Houses' distributable reserves and had been made by reference to statutory accounts that did not show a true and fair view of the company's finances.

The Court of Appeal in *Bairstow* determined that there was a requirement for any dividend to be made only in accordance with a company's financial statements, drawn up in the proper format and laid before the company at a general meeting. The court confirmed that this cannot be regarded as merely a procedural technicality and the mandatory nature of section 270 of the Companies Act 1985, now section 836 of the 2006 Act, must be fatal to any argument based on the *Duomatic* principle (*see "Care, skill and diligence" above*).

In *SSF Realisations Limited (In Liquidation) v Loch Fyne Oysters Limited*, the court held that the liability of directors and shareholders for a distribution exceeding the company's distributable profits was limited to the amount of the excess (*[2020] EWHC 3521 (Ch)*). The position may differ if the context is not, as in *SSF Realisations,* that only part of the distribution was out of capital, but that a lawful distribution could have been paid if the company had acted differently.

One of the directors was excused from liability under section 1157 of the 2006 Act on the grounds that he had no financial or accounting expertise and had been reliant on other directors with the relevant expertise. He had played a limited role and had acted honestly and reasonably.

Redundancies

The furlough scheme (the scheme), which the government established in March 2020 in response to the COVID-19 pandemic, is available until 31 September 2021. Under the scheme, the government will pay up to 60% of employees' wages (*see feature article "Furlough and COVID-19: looking for clarity"*). Directors should therefore consider furloughing employees, if redundancy is being contemplated due to the impact of the pandemic and the scheme is still open.

The directors should keep full and accurate minutes of the board's proposals. In respect of any decisions taken to make any employees redundant, they must ensure that consideration has been given to the company's obligations to consult collectively and to notify the SoS, to avoid risk of prosecution (*see feature article "Redundancy: the new normal"*).

A company must inform and consult the appropriate representatives of affected employees when 20 or more redundancies are proposed to take effect in a period of 90 days or fewer (*section 188, Trade Union and Labour Relations (Consolidation) Act 1992*) (TULRCA). The appropriate representatives of affected employees are either trade union representatives or, where no trade union is recognised, employee representatives who have been elected for the purposes of consultation. The directors should consider what steps will need to be taken to effect collective consultation. Consultation must last for a minimum of 30 days where between 20 and 99 redundancies are proposed or at least 45 days if 100 or more redundancies are proposed, before any dismissals take effect. When an employer proposes to dismiss fewer than 20 employees within a 90-day period, there is no requirement to consult collectively with representatives of affected employees. However, an employer is still required to follow a fair procedure if it wishes to avoid unfair dismissals.

The company must notify the SoS through the Department for Business, Enterprise & Industrial Strategy (BEIS) in writing using Form HR1 in a collective redundancy situation (*section 193, TULRCA*). The 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, reduced to at least 30 days for between 20 and 99 employees.

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Section 172 compliance

The GC100 guidance on directors' duties under section 172 of the Companies Act 2006 (2006 Act) (section 172) (GC100 guidance) explains that the factors under section 172 are intended to ensure that, in promoting success, the directors of a company consider the broader implications of their actions and create a culture so that when decisions are made, the wider impact of these decisions is taken into consideration (*see News brief "GC100 guidance on section 172: focus on directors' duties" and feature article "Company meetings: a digital switchover"*). The duties in this regard are to be fulfilled in accordance with the directors' duties under section 174 of the 2006 Act (*see "Care, skill and diligence" in the main text*).

As of 1 January 2019, most large private companies are required to report on the company's performance of the section 172 duty (*see feature article "Corporate governance reforms: widening responsibilities"*). This is a bid by the government to improve boardroom engagement and for directors to give greater consideration to the company's stakeholders. In their annual reports, companies must include statements on:

- Their compliance with section 172(1)(a) to (f).
- Their corporate governance arrangements and compliance with the UK Corporate Governance Code (the Code).

- How directors have engaged with employees.
- The company's business relationships.

A set of six high-level principles, the Wates principles of corporate governance, have been issued in order to help the largest private companies to meet their reporting requirements (*see News brief "Corporate governance for large private companies: a flexible framework"*). The Wates principles assist companies but do not have the same status as the Code (*see box "Corporate governance"*).

The third Wates principle requires the board and individual directors to have a clear understanding of their accountability and responsibilities. The board's policies and procedures should support effective decision-making and independent challenge. The chair, and company secretary if applicable, should periodically review the governance processes to confirm that they remain fit for purpose and consider any initiatives that could strengthen the governance of the company.

The fourth Wates principle states that a board has responsibility for a company's overall approach to strategic decision-making and effective financial and non-financial risk management, including reputational risk. The board must have oversight of risk and how it is managed, and provide appropriate accountability to stakeholders. The internal control systems put in place to manage and mitigate both emerging and principle risks will depend on the size and nature of the business. Some companies may delegate oversight of these matters to a committee.

In addition, the Department for Business, Energy & Industrial Strategy has issued some FAQs to assist in interpreting the new reporting requirements (*https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/755002/The_Companies__Miscellaneous_Reporting__Regulations_2018_QA_-_Publication_Version_2__1_.pdf*).

Corporate governance

For accounting periods beginning on or after 1 January 2019, companies with premium listings in the UK must either state in their annual report and accounts how they have complied with the UK Corporate Governance Code (the Code) or explain the reason why they have not complied (*www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf*).

The Code is designed around five pillars, also known as principles:

Board leadership and company purpose

To apply this principle, directors should establish prudent and effective controls to calculate risk, and a framework within which the workforce can raise matters of concern.

Division of responsibilities

To apply this principle, the chair should ensure the effective contribution of all non-executive directors, for example, through the provision of accurate, timely and clear information.

Composition, succession, and evaluation

To apply this principle, the composition of the board must be such that no one individual or group dominates the board, and there must be a clear division of responsibility between the executive and non-executive leadership of the board. Non-executive directors should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.

Audit, risk and internal control

To apply this principle, the board is to establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions, and satisfy itself on the integrity of financial and narrative statements.

Remuneration

To apply this principle, directors should not play a role in determining their own remuneration outcome. Policy on executive remuneration and determining director and senior management remuneration should be developed through a formal and transparent procedure.

Measures introduced in response to the COVID-19 pandemic

On 25 June 2020, the Corporate Insolvency and Governance Act 2020 (2020 Act) received Royal Assent (*www.practicallaw.com/w-026-5832; see News brief "Corporate Insolvency and Governance Bill: reforms to weather the storm"*). It applied retrospectively between 1 March and 30 September 2020 to all companies, with specific exceptions, such as building societies and banks.

The 2020 Act introduced temporary business protection measures so that, when determining whether a director is liable to contribute to the assets of a company for wrongful trading, the courts would assume that a director was not responsible for any worsening of the financial position of a company. These temporary provisions did not apply to any trading between 1 October 2020 and 25 November 2020. The measures were reintroduced on 26 November 2020, to apply to trading between 26 November 2020 and 30 April 2021, and were subsequently extended to 30 June 2021 (*www.practicallaw.com/w-030-7222*). However, the fraudulent trading and director disqualification regimes and general directors' duties continue to apply. Directors must still act responsibly and reasonably to protect value and minimise loss to the company. From 1 July 2021 onwards, the courts no longer assume that a director was not responsible for any worsening of the financial position of the company.

The government has implemented and recently extended other measures to ease cash flow and assist businesses that are suffering financially as a consequence of the COVID-19 pandemic, including extending:

- The current protection of commercial tenants from evictions until 25 March 2022 under the Business Tenancies (Protection from Forfeiture: Relevant Period) (Coronavirus) (England) (No 2) Regulations 2021 (*SI 2021/732*).
- The ban on landlords filing statutory demands and winding up petitions under the 2020 Act until 30 September 2021 where the debts relate to the pandemic (*www.practicallaw.com/w-032-0332*).
- The ban on landlords using the commercial rent arrears recovery procedure until 25 March 2022.

Under proposed legislation, outstanding debt that has accumulated while a business was forced to remain closed during the pandemic will be ring-fenced (*www.gov.uk/government/news/eviction-protection-extended-for-businesses-most-in-need*). Landlords will be expected to make allowances for the ring-fenced rent arrears and share the financial impact with their tenants, for example, by waiving some of the arrears or agreeing a long-term repayment plan.

If the landlord and tenant cannot reach agreement, an arbitration will ensure that parties come to a formal and legally binding agreement. However, businesses that can pay rent must do so, and tenants should start paying rent as soon as restrictions alter, and their businesses reopen.

The 2020 Act also introduced a new restructuring plan, which means that directors faced with financial distress can now decide between the new restructuring plan or the existing, well-established scheme of arrangement (*see News briefs "Sanctioning a restructuring plan: not a port for every storm" and "Virgin Atlantic restructuring plan: the first of many?"*). Both processes require members and creditors to be grouped into classes based on their rights. The classes then vote on whether to accept the proposed plan or scheme, and in each case final approval rests with the court.

A key feature of the restructuring plan is the ability to implement a cross-class cram down, which is a concept borrowed from the US Chapter 11 reorganisation process contained within the US Bankruptcy Code. Subject to certain conditions, this allows a company to apply to the court to approve a restructuring plan, even where there are dissenting classes of creditors or members that voted against the plan.

Minimising the risks of insolvent trading

To minimise the risks of trading insolvently, directors should:

- Develop a credible business plan (the plan) for the immediate term, and meet and regularly review the plan and the company's ongoing financial position (*see Briefing "Business restructuring and COVID-19: get the ball rolling"*).
- Consider contingency strategies to protect the interests of creditors should the plan prove to be unsuccessful.
- Consider whether the company is operating within its existing facilities and managing creditors. Factors to take into account include whether:
    - the company's financiers have withdrawn facilities, such as overdraft facilities, or suggested that they will be unable to provide ongoing support;
    - the company's shareholders have been informed of any additional working capital requirements and whether they are willing to extend additional working capital to the company;
    - the company has applied for a time-to-pay arrangement with HM Revenue & Customs to spread its current tax liabilities over three to 12 months;
    - the company has furloughed eligible employees while the COVID-19 furlough scheme is still running until 31 September 2021 (*see "Redundancies" in the main text*);
    - the company can meet payroll obligations for all employees who are not furloughed;
    - the company chose to defer payment of any VAT between 20 March to 30 June 2020, or any other payments, with the option to repay the deferred VAT in 11 monthly instalments between March 2021 and March 2022; and

    - the company can be sold as a going concern, with creditors paid in full and a return to shareholders, which is much less likely to be the case in the current market climate during the COVID-19 pandemic.

- Monitor the government's business advice and the various financial support schemes that the company is eligible for. When applying for funds, directors should provide full disclosure to the bank regarding the company's financial position. These forms of funding should only be used if they 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.
- Avoid, or at least carefully scrutinise, transactions that are not in the ordinary course of the business, minimise outgoings and preserve company funds. Ensure that any new credit, supplies and services are necessary for the continuation of the business. Creditors should not be specifically preferred, or transactions entered into at an undervalue, unless in good faith and critical to ensure the survival of the business or a solvent disposal or restructuring (*see "Preferences" and "Transactions at an undervalue" in the main text*).
- Maintain full and accurate minutes of company meetings, financial reviews and decisions (including dissenting views of individual directors), the reasons that decisions are reached and the information (particularly financial information) on which decisions are based. However, the GC100 guidance on directors' duties states that directors are not required to evidence their thought processes as this would create unnecessary process and inevitably expose directors to a greater and unacceptable risk of litigation (*see box "Section 172 compliance"*). Companies should communicate in writing with their creditors about repayment plans and document any calls or meetings with notes circulated afterwards.
- Work closely with the company's general counsel, CEO and other directors, and establish clear communication channels. As required by section 172 of the Companies Act 2006, directors must also consider factors including: the environment; employees; business conduct standards; relationships with suppliers and customers; and any other relevant circumstances (*see "Promoting success" in the main text"*).
- Obtain professional advice at the earliest opportunity from insolvency practitioners and lawyers, and engage with funders. Conduct a comparative analysis of the net deficiency of the company's assets compared to what the position would be if continued trading had not occurred and forecast a week in advance. Seek the advice of an insolvency practitioner on a weekly basis regarding the net deficiency analysis in respect of continued trading.

Litigation risk in the post-Covid world: steering the ship on stormy seas (PDF Version)

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