HOW OFFICERS / DIRECTORS OF FINANCIALLY DISTRESSED COMPANIES MAY SAFELY REORGANISE OR RESTRUCTURE THE FINANCIAL AFFAIRS AND OPERATIONS OF COMPANIES RATHER THAN PLACE THEM INTO LIQUIDATION PROCEEDINGS

This Memorandum has been prepared for the purpose of a presentation to be given by Patricia Godfrey at the International Insolvency Institute ("**III**") Conference on 11 and 12 June 2007 in New York.

1. JURISDICTION

England

This Memorandum focuses on important issues for officers/directors of financially distressed companies when seeking to reorganise or restructure the financial affairs and operations of a company rather than place it into liquidation proceedings. Although English law does not place an obligation on directors to file for insolvency when a company is insolvent or verging on insolvency, there is a large body of legislation that enables action to be taken against directors if they have failed to properly safeguard the interests of the company's creditors.

2. PERTINENT LEGAL RULES

2.1 Directors under English law

Under English law, the company is a separate legal entity which acts by persons appointed as directors. The day to day running of the company is carried out by the directors who are officers of the company. This power is delegated to them by the shareholders in the articles of association.

The Companies Act 1985 defines a "director" as including "any person occupying the position of a director, by whatever name called". This includes a person who is appointed as a director in accordance with the articles of association of a company (a de jure director) and also anyone who, although not validly appointed, nevertheless acts as a director (a de facto director). Notwithstanding the invalidity of their appointment, de facto directors are subject to the same duties and liabilities as de jure directors.

A shadow director is a person who is not holding himself out as a director. The Companies Act 1985 defines a "shadow director" as a person in accordance with whose directions or instructions the directors of the company are accustomed to act. However, a person is not deemed to be a shadow director by reason only that the directors act on advice given by that person in a professional capacity. Whether or not a person is a shadow director ultimately depends upon the real influence he/she has over the outcome of the corporate affairs of the company in question.

It is not an offence to be a shadow director. Furthermore, the indirect influence exerted by a person who falls within the statutory definition of "shadow director" who does not directly deal with, or claim the right to deal directly with, the company's assets would not normally be subject to the same fiduciary duties to the company as are owed by a de jure or de facto director. However, the policy underlying the definition of 'shadow director' was that a person who effectively controlled the activities of a company would be subject to the same statutory duties and disabilities as a person who was a de jure director and it is a position that attracts liability in certain circumstances. For instance, under the Insolvency Act 1986 ("IA"), the wrongful trading provision (see below) is expressly extended to apply to shadow directors.

2.2 **Duties of Directors**

Presently under English law, a director does not need to have any special training or licensing. A director is, however, in a fiduciary position in respect of the company, which means that he is in a position of trust and confidence in relation to it. This manifests itself in various common law fiduciary duties which are set out below, together with an explanation of his duties of skill and care. Reference is also made below to the Companies Act 2006 which, when fully implemented, will codify a number of the duties.

2.2.1 Duty to act bona fide in the best interests of the company

The primary duty of all directors is to act bona fide in what they consider is in the best interests of the company. The directors are obliged to act honestly and in good faith in the exercise of their powers.

This is essentially a subjective duty. A court will not consider it breached just because in the court's opinion, the particular exercise of power was not in the company's interests. The directors "must exercise their discretion *bona fide* in what they consider – not what a court may consider – is in the interests of a company": *Re Smith and Fawcett Ltd* [1942] Ch 304.

The subjective nature of the test reflects the long held reluctance of the courts to interfere with the commercial judgment of directors. The shareholders of a company are regarded as having entrusted the management of the company to its directors. Unless bad faith can be shown, the court will not interfere with the exercise of a director's management discretion in order to substitute its own judgment for that of the director.

However, the courts are becoming increasingly accustomed and willing to examine the quality of a decision. The courts may intervene where a decision reached by directors is so unreasonable that no reasonable body of directors could properly have reached it. The courts may also intervene where a board of directors can be shown to have taken into account irrelevant considerations or have failed to take into account relevant factors.

A number of basic obligations are imposed upon directors in order to comply with this duty:

- when taking any decision concerning the management of a company, the directors must positively apply their minds to the question of what are the interests of the company;
- the belief by the directors that a particular decision is in the interests of the company must be held honestly;
- a director must independently apply his mind to the interests of the company and exercise his discretion in accordance with those interests. He must not act unthinkingly on the instructions of a third party; and
- a director must not fetter his discretion in advance, for example by undertaking to a third party to exercise his discretion in a particular way.

2.2.2 Duty to act for proper purposes

Any power conferred on directors in the company's articles or by shareholders' resolution can only be exercised for a proper purpose; that is the purpose for which, on its proper interpretation, it was conferred. It must not be exercised for any collateral purpose. If the directors exercise a power for any other purpose, their conduct is open to challenge. It is no answer for the directors to maintain that they acted in good faith in the interests of the company. The onus of proving that the directors' purpose was improper is on those challenging the action.

A leading case has held that the court should not seek to find the proper purpose for which a power can be exercised but instead, should adopt a two-stage process. First, the court should seek to ascertain on the facts for what purpose the power was exercised. Secondly, having ascertained the purpose for which the power was exercised, it should consider whether that purpose was in all the circumstances a proper one.

In relation to the first stage, the courts will examine the exercise of the directors' discretion in order to ascertain the true purpose for which a power was exercised and will not accept, without further inquiry, the board's assertion that the power was exercised for a particular purpose. As to the second stage, it has been held that the courts should:

- ascertain, on a fair view, the nature of the power;
- define, as can best be done in light of modern conditions, the or some, limits within which it may be challenged;
- examine the substantial purpose for which it was exercised; and
- reach a conclusion as to whether that purpose was proper or not.

In doing so it will necessarily give credit to the good faith opinion of the directors, if such is found to exist, and will respect their judgment as to matters of management. Ultimately, this will be on a case-by-case basis.

2.2.3 No conflict rule

Directors must not place themselves in a position where their personal interests conflict or may conflict with the duties they owe to the company of which they are directors. A director must not put himself in a position in which his duty to the company conflicts or may conflict with his duty to another; for example, a second company of which he is director.

Where a director does place himself in a position of potential conflict, the director must ensure it is disclosed to and approved by the company by resolution of the shareholders, otherwise any resulting transaction entered into by the company is voidable at the instance of the company and the director would be liable to account to the company for any profit made from his position.

2.2.4 Duty to act with reasonable skill, care and diligence

A director also owes duties of skill and care based on the following principles:

(a) a director must exhibit a degree of skill and care in the performance of his duties;

(b) a director is not bound to give continuous attention to the affairs of the company (although, in the case of an executive director, a high degree of attention is likely to be required by their contract of employment); and

(c) a director must also exercise his duties diligently and must keep himself informed about the company's affairs. However, this does not prevent a director from relying on the experience and expertise of his colleagues nor, generally, does it prevent sensible delegation of tasks, provided the director does not thereby try to absolve himself of responsibility.

The standard of care that a director must satisfy is the higher of a subjective test and an objective test. A director must take such actions as would be taken by a reasonably diligent person, having both (i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as that director; and (ii) the general knowledge, skill and experience that that director actually has. A director is therefore expected to be sufficiently qualified and experienced to be able to fulfil the functions that he might reasonably be expected to carry out, and a particularly highly qualified or experienced director must exercise that high level of skill and expertise. More specific standards apply when a company encounters financial difficulties (see below).

The degree of diligence required of a director depends on the facts of each particular case. One director among many, or a director who is given little effective power, need not perhaps be as diligent as one on whom the company ordinarily relies. However, each director, whether executive or non-executive, is responsible for the proper management of the company's affairs.

The wrongful trading provision in the Insolvency Act 1986 (see below) requires a similar standard of skill and care from the directors if they are to avoid liability for wrongful trading. This provision (IA section 214) refers to:

"…*a reasonably diligent person having both:*

(a) *the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company; and*

(b) *the general knowledge, skill and experience that that director has."*

It is often appropriate for directors to take expert advice from outsiders (for example, accountants), but on taking such advice, the directors must still ultimately exercise their own discretion in taking a decision. They must not delegate the decision itself to the outside expert. They must also exercise reasonable care in choosing an appropriate adviser.

2.3 Impact of Companies Act 2006 on general duties of directors

The Companies Act 2006 received Royal Assent on 8 November 2006 and the government intends to have implemented the whole of the Act by October 2008.

We are still waiting for the regulations setting out how the new law will be applied to existing companies, details of when and how the new provisions are to be brought into force and other details that the Act specifies are to be contained in secondary legislation. The government also intends to publish guidelines on some parts of the Act.

The Act contains a statutory code as to the general duties that a director owes to the company. These duties are based on, and are intended to replace, the common law rules and equitable principles (as set out above) (section 170). Here is how the Act describes them:

- To act in accordance with the company's constitution and only exercise powers for the purposes for which they are conferred (section 171).
- To act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (section 172), and in doing so have regard (amongst 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; and

- the need to act fairly as between members of the company.

This core duty enshrines what is referred to as the principle of "enlightened shareholder value".

- To exercise independent judgment (section 173).

  This duty does not prevent a director from acting in accordance with an agreement entered into by the company or as authorised by the company's constitution.

- To exercise reasonable care, skill and diligence (section 174).

- To avoid actual or possible conflicts of interests or duties (other than a conflict arising in relation to a transaction or arrangement with the company) unless the matter has been authorised by the independent directors (section 175).

  A public company's articles will have to include express provision permitting such authorisation.

- Not to accept benefits from third parties conferred by reason of his directorship, unless the acceptance cannot reasonably be regarded as likely to give rise to a conflict (section 176).

- To declare to the other directors his interest in a proposed, or existing, transaction or arrangement with the company (sections 177 and 182).

While directors will appreciate the clarity of this statutory statement of their general duties, there will be uncertainty as to how to interpret and apply these provisions in practice, at least until it is seen how the courts develop the law in this area. How can directors do as the Act requires, which is to have regard to the common law rules and equitable principles in interpreting and applying the statutory provisions (section 170) if, as it does, the legislation describes the duties differently from the ways in which the courts have described them?

Directors will want to understand their duties in relation to conflicts and how to avoid, or obtain prior authorisation in respect of, them. The wording of a company's articles in relation to the authorisation of conflicts and the procedures for them (such as exclusion from voting at board meetings) will need to be considered carefully. A public company may wish to amend its articles to enable the independent directors to authorise a conflict.

The government announced in February 2007 that the provisions for this statutory code will be brought into force on 1 October 2007, apart from provisions relating to directors' conflict of interest duties which will take effect from 1 October 2008.

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2.4 Insolvency: English law definition

A company's inability to pay its debts within the meaning of section 123 of the IA alters in certain respects the nature of the duties and obligations of its directors and necessarily affects their considerations.

Generally, directors of a company owe no duty to creditors of a company unless and until financial difficulties arise. It is clear that the directors' duties shift to being duties to the creditors alone when the directors knew or should have concluded there was no reasonable prospect of the company avoiding going into insolvent liquidation. Statutory duties arise at this point (wrongful trading provisions below). It is, however, not clear when the shift actually happens. It is generally accepted under common law that the shift probably happens as soon as the company becomes unable to pay its debts, at which time the interests of the creditors alone become paramount. Failure to take into account creditors' interests from this point on may result in exposure of the directors under the misfeasance provisions of the IA (see below).

Under English insolvency law, directors of a company can, in some circumstances, be held liable to compensate an insolvent company for losses incurred as a result of their actions or omissions or breaches of their duties to the company, that occurred some time prior to, or after, the point of insolvency was reached. Some of the main provisions under which such liability might arise are summarised below. Such actions or omissions and breaches of duty may also result in the directors being disqualified under the Company Directors Disqualification Act 1986 ("CDDA") from acting as directors of a company, or being otherwise involved in the formation, promotion or management of a company for any period of between two and fifteen years.

2.4.1 Inability to pay debts – what does it mean?

In England, a company is deemed to be unable to pay its debts under section 123 of the IA in the following circumstances:

- where the company is unable to pay its debts as they fall due and this is proved to the court's satisfaction. This is commonly referred to as the **cash flow** test; <u>and/or</u>
- where the company fails, within three weeks after its service on it, to pay or settle to the **reasonable** satisfaction of the creditor, a statutory demand (a form of written demand for – presently - sums over £750), served by a creditor on it; <u>and/or</u>
- execution or other process issued on a court judgment or order obtained against the company, is returned unsatisfied in whole or in part; <u>and/or</u>

- where the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities, and this is proved to the court's satisfaction. This is commonly referred to as the **balance sheet** test.

It will be noted that we have highlighted above (by underlining "and/or") that each of these deeming provisions works alone, as well as together. That is, a company will be deemed unable to pay its debts if it is, say, cash flow insolvent even though it is balance sheet solvent.

In the context of this section, the terms "debt" and "liability" are widely defined. They include all debts and liabilities, whether or not (among other things):

- present or future;
- certain or contingent;
- a fixed sum or capable of only being ascertained as a matter of opinion; or
- payable in money or money's worth, or arising under statute, contract, as a consequence of breach of trust, tort, bailment or as a result of an obligation to make restitution.

2.5 **Insolvency Offences**

2.5.1 Wrongful trading (s.214)

This provision applies only if a company goes into liquidation.

A director may be ordered by the court to make contributions (compensation) to the company's assets if, at some time before the commencement of the liquidation of the company, that director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation (the "**Insolvency Point**") and he did not take <u>every</u> step after the Insolvency Point was reached, with a view to minimising the potential loss to the company's creditors. It should be stressed that this section is not intended to simply prevent continued trading, but catches anything that is done or has omitted to be done by the company after the Insolvency Point, that causes/increases the loss to its creditors.

The director is judged on the basis of what he knew or ought to have known, the conclusions he should have reached and the steps he should have taken, as against a reasonably diligent person having both:

- his general knowledge, skill and experience; and
- the general knowledge, skill and experience that might reasonably be expected of someone carrying out the same functions as him.

What "every step" means or requires is not defined in the IA. It depends upon the circumstances of each case as to what should be done. It may be that the only realistic option available in one case is to take immediate steps to wind up the company, but this may not be an appropriate step in another case. What is unlikely ever to be appropriate once the Insolvency Point is reached, is for the directors simply to ignore the situation and continue as normal, or continue "trading" the company with some distant (unrealistic) hope that fortunes might change.

It is generally accepted that it was intended that the burden on directors in respect of taking "every step" should be heavy, the word "reasonable" having been expressly rejected by Parliament when this section was enacted.

If a director is found to be in breach of the wrongful trading provision, he is liable under IA section 214 to make such contributions to the company's assets as the court thinks proper, unless he can satisfy the court that after he first knew or ought to have concluded as above (assuming for this purpose that he knew), he took every step that he ought to have taken with a view to minimising the potential loss to the company's creditors. No guidance is given in the IA as to how this compensation should be made up. The cases decided so far indicate that it should be compensatory rather than penal, calculated with reference to the amount of the company's assets that have been depleted by the director's conduct. Loss which could not have been reasonably foreseen as a consequence of continued trading should not be taken into account, nor should loss attributable to other causes which would have been incurred, in any event, such as market conditions. The statements that have been made so far are for general guidance rather than statements of principle. Each case will be looked at on its own facts.

The court also has additional powers under the IA to secure any such contribution against the assets of the person (eg. a director) found to have wrongfully traded, and if they are creditors of the company in question, to order that their debts be deferred to all of the other debts of the company and full interest on those debts.

Only a liquidator may bring wrongful trading proceedings.

2.5.2 Fraudulent trading (section 213)

This provision applies only if a company goes into liquidation.

Section 213 of the IA provides that, where it becomes apparent during the course of the winding up of the company, that any business of the company has been carried out with the intent:

- to defraud its creditors; or
- to defraud the creditors of any other person; or
- for any fraudulent purpose;

the liquidator may make an application to the court. If the court finds any persons knowingly party to the carrying on of the business in this manner, it can make those persons liable to make any such contribution to the company's assets as it thinks proper.

The amount of the contributions are not restricted to what is required to compensate the company for the person's actions, but may also contain a penal element. The court has additional powers under the IA to secure the contribution against the assets of the person (eg. a director) found to have fraudulently traded. Also if they are creditors of the company in question, the court can order that their debts be deferred to all other debts of the company and interest payable on those debts.

It is difficult to bring an action for fraudulent trading as, in order to constitute fraud, there must be actual dishonesty involving real moral blame. There must be a positive action; a deliberate desire or intention to deceive, or there must be recklessness.

Only a liquidator can make an application under section 213 of the IA.

2.5.3 Misfeasance (section 212)

This provision applies only if a company goes into liquidation.

It is however, only a procedural section. It does not create a cause of action against a director (contrast this to the wrongful trading and fraudulent trading provisions above) but rather, provides a remedy where there is an existing cause of action (for example, where the director has clearly breached one of his common law duties already covered in this note) falling within its parameters.

The liquidator or any disgruntled creditor or ,with leave, any contributory (shareholder), even though he will not benefit directly from the order, may bring an action against a person who is or has been a director of the company who has "misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company". The court may order that person:

- "to repay, restore or account for the money or property or any part of it, with interest at such rate as the court thinks just; or
- to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just".

The discretionary relief from liability by the court available under section 727(1) of the Companies Act 1985 can apply to reduce any liability in respect of a finding of misfeasance under the IA.

2.6 **Disqualification**

2.6.1 Disqualification proceedings (CDDA)

Liquidators, administrators and administrative receivers appointed in relation to a company are under an obligation to provide to the Secretary of State a report on the conduct of its directors (past or present) where, in general terms, they are of the view that the directors are unfit to be concerned in the management of a company. The purpose of this report is to enable the Secretary of State to take a view about whether or not to take disqualification proceedings against a director pursuant to the CDDA. Matters taken into account by the relevant insolvency office-holder include wrongful and fraudulent trading by directors and their participation in transactions at an undervalue or preferences (see below), or any breaches by the directors of their fiduciary duties.

A successful disqualification application may result in disqualification of a director for a period of between two years (for less serious offences) and fifteen years (for very serious offences).

The disqualification means that the director cannot act as a director of a company or be involved in the promotion, formation or management of a company during the disqualification period, save with the leave of the court.

Only the Secretary of State can bring disqualification proceedings.

2.7 Antecedent transactions

2.7.1 Transactions at an undervalue (s.238)

This applies when a company goes into liquidation or administration.

Where a company makes a gift to another party, or enters into a transaction with another party for a consideration, the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company, that transaction is vulnerable to challenge under IA section 238 if, in addition:

- it occurred within two years prior to formal steps being taken under IA to appoint an administrator to the company or it entering administration, or the commencement of its winding-up; and
- at the time of the transaction, the company was unable to pay its debts within the meaning of IA section 123, or became unable to do so as a consequence of that transaction; and
- the only possible defence does not apply; namely that the company entered into the transaction in question in good faith for the purpose of carrying on its business and at the time of doing so, reasonably believed that the transaction would benefit the company.

If the transaction is entered into with a connected party, inability to pay debts is presumed. Albeit this presumption is rebuttable (that is, the connected party may be able to rebut the presumption on the facts).

If the court is satisfied that the transaction in question is a transaction at an undervalue, it has a wide discretion to make any order it thinks fit for restoring the position to what it would have been had the company not entered into the transaction (a "Restoration

Order"). This might mean ordering that the transaction be reversed, or indeed, at least in theory, requiring the directors to make a compensatory payment.

Only a liquidator or an administrator may bring IA section 238 proceedings.

2.7.2 Transactions defrauding creditors (IA section 423)

Where a company makes a gift or enters into any transaction at an undervalue of the nature caught by IA section 238, with the purpose of (1) putting assets beyond the reach of someone who is making or may at some future time make a claim against it, or (2) prejudicing the interests of such a person in relation to such a claim that it is making or might make, then the court may make an order restoring the position to what it otherwise would have been and for protecting the interests of the persons who are victims of the transaction. Once again, what order the court might make is left to its discretion which is very wide.

Transactions defrauding creditors are therefore, in effect, transactions at an undervalue (ie. IA section 238 transactions) but with the additional requirement that there must have been a motive behind the undervalue transfer. Specifically, IA section 423 differs from IA section 238 in that:

- The purpose of the transaction is important under IA section 423 whereas under IA section 238 the purpose is irrelevant. Current case law suggests that it is the substantial purpose behind the transaction that matters (that is to avoid or prejudice creditors, whether they are presently known or unknown).
- It is not dependant upon the company being unable to pay its debts or becoming so as a consequence of the transaction. Indeed, at the time of the transaction, the company need not even have had any creditors. Current case law has brought within the scope of this section an attempt by an individual to structure his affairs to avoid exposure to creditors in the future, although at the time of the transaction he had no exposure.
- There are no specified time limits in which the transaction must have occurred (that is, unlike under IA section 238, waiting two years will not reduce the potential risk);

The company need never become subject to any formal insolvency process. If it is not subject to any insolvency process, any "victim" of the transaction, usually a creditor, can make the application against the company (or individual).

2.7.3 Preferences (s.239)

Like IA section 238, this section applies when a company goes into liquidation or administration.

A company gives a preference if it does anything or suffers anything to be done which has the effect of putting its creditors or any surety or guarantor of the company's liabilities into a position which, in the event of the company going into insolvent liquidation, will be better than the position that they would have been in if that thing had not been done (eg. paying off a guaranteed debt). Further conditions are that:

- the transaction must have been entered into within six months (or two years where the recipient is connected) before formal steps were taken under the IA to appoint an administrator to the company or it entering administration, or the commencement of its winding-up; and
- at the time of the transaction, the company must have been unable to pay its debts within the meaning of IA section 123 or became so as a result of the transaction. Unlike IA section 238, this is not presumed in favour of connected parties; and
- in giving the preference, the company must have been influenced by a "desire" to put the party receiving it into a better position. This is a subjective test. It is the company's mindset that is relevant, not the mindset of the other party to the transaction. The mindset is presumed if the preference is given to a party connected to the company, albeit this presumption can be rebutted.

Once again, the court has a wide discretion to make a Restoration Order.

Only a liquidator or administrator may bring IA section 239 proceedings.

2.8 Impact of Companies Act 2006 on a private company giving financial assistance for the purchase of its own shares

The Companies Act 2006 will abolish the general prohibition on private companies giving financial assistance for the purpose of the purchase of the company's shares and will also repeal the 'whitewash' procedure contained in the Companies Act 1985. This procedure is currently used to allow a private company to give financial assistance lawfully. The result will be that private companies will no longer be subject to the statutory prohibition from giving financial assistance for the purchase of their own, or their private holding company's shares without the need to engage the whitewash procedure. Directors of those companies will no longer be potentially criminally liable for breach of the prohibition. The Act will retain the prohibition of financial assistance by a public company or by its subsidiaries for the purpose of the purchase of the public company's shares (section 678) and financial assistance by a public company for the purpose of the purchase of its holding company's shares, where that holding company is a private company (section 679).

One of the key aspects of the soon to be abolished whitewash procedure is that the directors of the company giving the financial assistance are required to swear a statutory declaration as to the solvency of the company both immediately following the assistance and for the next 12 months. Furthermore, the directors are required to obtain an auditor's report to support the statutory declaration. Therefore, the whitewash procedure forces the directors to consider carefully the solvency of the company before allowing financial assistance transactions to proceed.

However, upon the whitewash procedure becoming redundant, in the event that a private company gives financial assistance, the directors will no longer be required to give a considered declaration of solvency prior to the transaction. Therefore, if at the time of giving the financial assistance the company is either insolvent or becomes insolvent as a result of the transaction, the directors may be exposed to personal civil liabilities or disqualification proceedings, or the financial assistance transaction may be reversed for some insolvency related reason. This is a risk because the financial assistance transaction may reduce the assets available to creditors and if this occurs at a time when the company is insolvent, the transaction could be classed, amongst other things, as wrongful trading.

Therefore, removal of the whitewash procedure will mean that the directors of private companies will need to keep an eye on the solvency of the company if they are to avoid falling foul of the insolvency related offences in such circumstances. They may consider that it is necessary not only to perform due diligence but also to obtain an auditor's report to establish that the company could not be regarded as insolvent following the financial assistance transaction.

These statutory changes are expected to take effect from 1 October 2008.

3. IMPACT OF INSURANCE AND INDEMNITIES

3.1 Indemnification of a director

The Companies Act 1985 limits the ability of companies to protect directors from liability for negligence or breach of duty (sections 309A to 309C).

The general rule is that any provision (which may be in the articles of association and/or a separate contract) whereby a director is exempted from or indemnified by the company or an associated company in connection with any negligence, default, breach of duty or breach of trust by him in relation to the company of which he is director, is void (section 309A).

This rule does not prevent a company from purchasing and maintaining insurance for a director against his liability to the company of which he is a director or an associated company.

The rule does not apply to a "qualifying third party indemnity provision"; that is, a provision which does not indemnify a director against any of the following:

(a) liability to the company or associated companies; or

(b) criminal fines or penalties imposed by regulations; or

(c) costs associated with defending criminal proceedings in which the director is convicted, or civil proceedings brought by the company or an associated company where judgment is given against him (in each case where there is no further right of appeal).

However, the existence of any qualifying third party indemnity provision must be disclosed in the directors' report, which forms part of the company's annual accounts.

The company is permitted to make loans to a director for the purposes of his defending criminal or civil proceedings, except that the loan must be repaid if the director is convicted or if judgment is given against him and there is no further right of appeal (section 337A Companies Act 1985).

3.2 **Companies Act 2006**

The Act will provide a new exception to the current rule that restricts a company from indemnifying its, or its associated companies', directors. This new exception will apply to a director of a company that is a trustee of an occupational pension scheme. A provision that indemnifies such a director against liability incurred in connection with the company's activities as trustee of the scheme will not be void, as long as it meets the other detailed requirements of such a "qualifying pension scheme indemnity provision" (section 235 CA 2006).

This change will be welcomed by pension trustees as it will allow a company to indemnify a director of an associated company that is acting as a trustee of the group's pension scheme, which is what it was able to do before the law on directors' indemnities was changed in April 2005.

The new provision is expected to be brought into force from 1 October 2007.

3.3 **Directors' and Officers' Insurance**

In the past, few claims were made in the UK against directors and officers in their personal capacity. However, this is changing with increased corporate governance and the increased risk of investigation by regulators. As a result of this, Directors' and Officers' ('D&O') Liability Insurance is widely purchased by companies as a means of protecting the directors and officers of a company from personal liability. There is more focus on the possibility of class actions against directors of large UK companies, although this is not a major driver for D&O insurance at present.

Section 310 of the Companies Act 1985 establishes that a company is able to validly effect insurance for its directors and officers and also indemnify a director for his legal costs as they are incurred. Before purchasing D&O insurance, the directors must check the company's articles of association to ensure that they give authority to the directors to purchase such insurance.

D&O is an insurance to indemnify the directors and officers of a company and may also extend to employees with a managerial or supervisory role, although this will depend on the terms of the particular policy.

In order to establish a valid claim under the policy, the relevant director, officer or employee will have to prove, on a balance of probabilities, that they have suffered loss which resulted from a claim made against the insured. Alternatively, the loss may be that of the company having indemnified the insured. The claim must be in respect of a wrongful act performed solely by reason of their acting as a director, officer or employee of the company. Furthermore, policies tend to provide cover on a "claims made" basis meaning that the claim must arise during the period of the policy. 'Wrongful act' is commonly broadly defined as any actual or alleged breach of trust, breach of duty, neglect, error, misstatement, misleading statement, omission or other act wrongfully committed or attempted or breach of warranty or authority. This includes wrongful trading within section 214 of the IA. Losses resulting from the claim for a wrongful act generally include sums which directors become liable to pay as damages, as well as legal costs incurred in the defence or settlement of claims. As a matter of public policy you cannot buy insurance to cover a criminal act, however, the insurer will usually cover defence costs in criminal proceedings where the fine or penalty itself is excluded from the cover. If the defence is unsuccessful and a criminal act is established the insurer may be able to claw back the defence costs.

The policy will also include specific exclusions, although what these will be to an extent depends on the particular circumstances and the risk perceived by the insurer. However, some typical exclusions are those: (i) required to satisfy considerations of public policy (as considered above), i.e. involving the director's dishonesty, fraud or malicious conduct; indemnity for civil or criminal fines or other penalties; (ii) concerning risks which should be insured by more specific policies eg. civil damages flowing from employers' or public/products liability for breach of professional duty.

There may be specific liquidation exclusions or other insolvency exclusions in the policy. For example, certain policies may state that any claims triggered by insolvency will be not covered by the policy. However, whether it is possible to find a D&O policy that will cover insolvency claims is an issue that falls within the domain of an insurance broker. The exclusions contained in the policy will be determined by reference to the terms that the insurance market will offer.

Some key issues to consider when assessing proposed cover:

- If the cover is written on a worldwide basis on a company's global business, you need to consider whether the limit of indemnity is adequate as the cover will relate to claims arising in various jurisdictions and to a large number of people.

- If a director or officer retires from his position in the company and the policy does not continue, the director may be at risk as the cover is written on a "claims made" basis. Therefore, the director or officer needs cover at the time the claim is brought. Usually the policy will entitle the company to purchase a period of cover known as the

"Discovery Period". This provides cover for claims, after the date the policy ends, for wrongful acts by the director prior to expiry of the policy.

- The policy may contain an "insured-v-insured" exclusion which excludes cover for a director when he is sued by the company, the liquidator or a fellow director.

Typical policy limits are set on an aggregate basis which means that there is one specified "pot" of money available to cover all claims on the policy in a specified period. As a result, funds could be eroded by a number of claims leaving insufficient cover towards the end of the policy year.

If the director is a member of the Institute of Directors he may obtain personal liability cover. Such a policy would cover all directorships of a director and alone it is likely to be inadequate. However, it may be a useful back-up if, for some reason, there is no D&O insurance policy in place.

4. IMPACT OF OBTAINING ADVICE OF OUTSIDE CONSULTANTS

There are a number of suggested steps an officer/director can take in an attempt to avoid personal liability where a company is insolvent or verging on insolvency. In this regard, English insolvency laws present certain challenges. Whereas an office/director may know that it should act in the best interests of creditors where a business is insolvent or verging on insolvency, the question arises: when is a company insolvent? Unlike certain other jurisdictions, England has two tests, the cash flow test and the balance sheet test (as set out previously in this Memorandum). If the company accounts are accurate, an office/director should be able to deduce when a company is in difficulties and verging on insolvency. Of note, the English courts have said that the inability to read and comprehend management accounts is no excuse for not taking appropriate action. If that is the case, a suitably qualified accountant must be retained to advise on the significance of the figures (*Re. Continental Assurance Co. of London plc (No. 1)* [1997] 1 BCLC 48).

Insolvency professionals will typically emphasise to directors of distressed companies the dire personal consequences which can ensue from wrongful or fraudulent trading. As a result of the various personal penalties that can arise for officers and directors when a company becomes subject to a formal insolvency process, those running a business will wish to ensure they take every step possible to minimise loss to creditors. This will include seeking advice from external consultants. A typical list of steps a well advised board of directors will take to avoid personal liability include the following:

(1) Take appropriate external professional advice, including specialist insolvency advice, as soon as possible. It is customary in times of crisis in England for a board to obtain both specialist legal and accountancy advice.

(2) Insist on frequent board meetings with all key decisions being carefully minuted. The precise regularity will depend on the circumstances in individual cases.

(3) Ensure up to date financial information is maintained and carefully reviewed at board meetings.

(4) Regularly monitor budgets and forecasts. Carefully review any shortfalls which potentially impact adversely on the position of the company's creditors.

(5) Ensure major creditors are kept fully informed of key developments in an effort to get their support for any restructuring measures.

(6) Ensure the board carefully reviews any advice relating to formal insolvency processes. Ensure major decisions are recorded in detail and if a decision is taken not to follow formal advice, make sure such reasons are explicitly set out in the board minutes.

(7) Dissenting directors should ensure their views are recorded in detail in the minutes. Resignation is a remedy of last resort.

(8) Where a complex and detailed restructuring is underway, directors are well advised to maintain 'Plan B' as a contingency measure, should 'Plan A' not prove feasible.

(9) Given the need to safeguard the interests of the company's creditors, the board will need to ensure that unnecessary credit is not incurred and opportunities are taken to cut costs and overheads wherever possible. This may include disposing of unprofitable or loss making parts of the business where appropriate.

(10) Last but not least, the officers and directors will need to be satisfied that the business is viable either as a whole or in part. In addition to seeking appropriate professional advice on this aspect, a detailed business plan will need to be in place and subject to frequent and careful review.

While every care has been taken in producing this note, it is general in nature and does not purport to be comprehensive. It is not intended to constitute legal advice. Specific legal advice should be sought before taking or refraining from taking any action in relation to the matters mentioned in this document.

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