UK Directors’ Duties: Practical considerations in distressed situations

Directors’ Duties

Against the backdrop of Brexit, the UK finds itself in a prolonged period of economic uncertainty. It is likely that a rising number of UK companies will experience a period of financial distress.

With this shift comes a change in focus for boards of directors (the Board) who may be unfamiliar with the specific challenges of distress, and this can drive varying behaviours:

- Inertia in decision making or potential “knee jerk” reactions; and
- Director nervousness about their personal responsibilities and position.

Directors’ duties and the consequences of failing to discharge them appropriately are set out in the Companies Act 2006 (CA2006). In certain circumstances, these duties may conflict with the shareholders’ agenda. For example, in the UK, when a company enters the zone of insolvency, a director’s duties are to its creditors as opposed to its shareholders.

If a company becomes distressed, the Board needs the independence and experience to deal with such potential conflicts:

- Creditors require the confidence that the Board is acting in their interests;
- The perception of independence can protect shareholder directors reputationally; and
- The Board should consider suitable governance structures (such as sub-committees) to allow shareholder directors considering new money provision to focus on their role as potential investors and to allow the independent directors to focus on the company agenda.

This paper explores how directors’ duties and responsibilities change in situations of distress and provides practical considerations for Boards either entering into or already in the zone of insolvency.
What are the different types of director?

There are four types of director, only two of which are formally appointed.

| EXECUTIVE DIRECTOR | • Employed by the company (usually full time salaried) | • Responsible for the day to day running of the company | • Entrusted to ensure that information put before the Board is an accurate reflection of their understanding of the affairs of the company |
| NON EXECUTIVE DIRECTOR | • Not employed by the company (usually fixed director fee) | • Provide independent guidance to the executive directors and issues facing the company |
| DE FACTO DIRECTOR | • A director “in fact” or “in reality” | • Not formally appointed at Companies House but who nevertheless acts as a director and holds themselves out to third parties as a director |
| SHADOW DIRECTOR | • “A person in accordance with whose directions or instructions the directors of the company are accustomed to act” (Section 251 of CA2006) | • Advice given in a professional capacity (e.g. lawyers / accountants) is not sufficient to make a person a shadow director |

It is vital to confirm at the outset of a distressed situation which individuals meet the criteria and definition of a director of any type. De facto directors and shadow directors cannot avoid directors’ duties or liabilities just because they have not been validly appointed. Individuals representing a shareholder institution / lender are more susceptible to being classified as de facto / shadow directors and should establish their status early in the restructuring process.

What are the duties of a director?

A company acts through two bodies; its shareholders and its Board. The directors are effectively the agents of the company, appointed by its shareholders to manage its day to day affairs. The Board of a company is primarily responsible for:

• determining the company’s strategic objectives and policies;
• monitoring progress towards achieving the objectives and policies;
• appointing senior management;
• accounting for the company’s activities to relevant parties (e.g. shareholders); and
• ensuring the company meets its statutory obligations.

Directors owe their general duties to the company to which they are a director of and not other group companies or individual shareholders.

In addition to the duties set out opposite, the Board must comply with all other laws and regulations applicable to it, including financial, tax, environmental and health.

Directors should be aware of the seven duties in the CA2006 listed below:

1. To act within the powers of the company
2. To act in a way the director considers in good faith is most likely to promote the success of the company for the benefits of its members as a whole
3. To exercise independent judgement
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts (or possible conflicts) between the interests of the director and the company
6. Not to accept benefits from third parties by reason of being a director or doing anything as a director
7. To declare any interest (direct / indirect) in a proposed transaction

In a distressed situation, the overarching consideration for the Board is to determine whether they ought to conclude that there is a reasonable prospect of achieving a solvent outcome. Assessing and establishing this in a restructuring situation is likely to be both complex and require experience. It is therefore advisable that the Board retains restructuring professionals who have experience of managing companies in distress.

thmpartners.com It should be noted the guidance set out in this paper is for general information only and is not intended to provide legal advice.
What are the additional considerations for directors in distressed situations?

Directors have a primary duty under Section 172 of CA2006 to promote the success of the company. This usually refers to making sufficient profit or acting in shareholders’ best interests to the exclusion of most other groups or categories of stakeholder in the company.

UK statute provides that when a company reaches the zone of insolvency then directors’ duties alter and the Board must prioritise the interests of creditors of the company over those of the shareholders.

This is a profound shift for a Board primarily accustomed to working for and to a shareholder agenda, particularly where some of the directors are shareholders. A director who works directly for an institution that holds shares in a company may find this difficult.

In this instance, the Board may benefit from independent directors who have no pre-existing allegiance in order to both challenge the status quo and to give comfort to external stakeholders. For companies in distress, there are additional further significant considerations for directors:

- Cash flow forecasting
- Management accounts
- Early engagement with financial and legal advisers and key stakeholders
- Restructuring / legal advice
- Appoint CRO
- Appoint other advisers
- Stakeholder management
- Continually assess the ongoing viability of the business and the position of all stakeholders. Carefully consider all options
- Options analysis
- Risk assessment
- Risk register
- Regular board meetings and frequent communication with stakeholders
- Regular board meetings
- Minutes of meetings
- Communication with stakeholders

What should Boards do in distressed situations?

A director of a distressed business faces increased pressure on their time due to additional operational and legal challenges and the need to proactively manage a much larger stakeholder group (including financial creditors). It is of paramount importance that the Board takes various steps to protect (ie not to worsen) the position of its creditors.

The table below provides a framework for identifying and managing companies in distress.

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**Insolvency Tests**
- Company is unable to pay its debts as they fall due ("cash flow test")
- Liabilities (current / future and prospective) exceed assets ("balance sheet test")
- An execution or judgement against the company is unsatisfied
- A statutory demand is served on the company and the debt is not satisfied or secured to the creditors’ satisfaction, or legitimately disputed within 21 days

**Filing Requirement**
- There is no fixed time period to initiate insolvency proceedings on the grounds of the insolvency tests
- Directors usually commence proceedings at a point in time so as to try to minimise risk of personal liability for wrongful trading

**Director Liability**
- A liquidator or an administrator can bring (or assign to a creditor) an action against a director, former directors and ‘shadow directors’ for wrongful trading
- Directors can be liable for fraudulent trading where it appears the business of the company has been carried on with the intent to defraud creditors or for any fraudulent purpose

**Shift in Director Duties**
- When a company reaches the zone of insolvency then directors’ duties alter and the Board must prioritise the interests of the creditors of the company over those of the shareholders

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Implementation of a financial restructuring requires a clear plan, often led by a Chief Restructuring Officer (CRO) who has both the unique skill set and independence to lead a company through a restructuring situation. Allowing management time to run the business is a critical component in the delivery of a successful restructuring process and in avoiding value erosion.

What are the implications if a director breaches their duties?
If a director is found to be in breach of their duties, they are liable to fines, being struck off from acting as a director and not being able to act in future, and potential criminal liability. This represents a reputational risk for all directors, especially those retained by institutions and appointed to portfolio company Boards. It is therefore of paramount importance that a director receives appropriate advice and support in discharging their duties.

What protections are available to directors?
Generally, directors will seek both directors and officers (D&O) insurance and an indemnity letter from the company to protect themselves in the event certain proceedings are initiated by third parties.

D&O insurance cover is intended to protect directors in the event that claims are made against them in relation to the discharge of their duties. Careful attention should be paid to the exclusions and limitations in a D&O insurance policy.

CA2006 allows for a company to provide a limited indemnity to a director in relation to the liability of that director to third parties. The indemnity cannot cover criminal and regulatory fines or legal fees in the event of an unsuccessful criminal defence.

It is important to note that no indemnity can be given in relation to the liability of a director to the company itself (which is a much more substantial risk), although a company can agree to lend funds to pay a director’s legal fees even for an action brought by the company (if the director is unsuccessful in his defence the fees would be repayable by him to the company).

Recent cases where THM has taken director appointments

<table>
<thead>
<tr>
<th>Company</th>
<th>Debt</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>STEINHOFF</td>
<td>€1bn debt</td>
<td>Independent Director</td>
</tr>
<tr>
<td>BMI Healthcare</td>
<td>£2.3bn* debt</td>
<td>Director and CRO</td>
</tr>
<tr>
<td>Jack Wolfskin</td>
<td>€365m debt</td>
<td>Director and CRO</td>
</tr>
<tr>
<td>DELSEY™</td>
<td>€200m debt</td>
<td>Director and CRO</td>
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</tbody>
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Contact Us

THM specialises in advising the Boards of distressed companies and in taking director appointments. If you would like to discuss any of the issues or practical considerations outlined above, please contact:

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