

Directors' eAlert

Directors' responsibilities should their company become insolvent

Directors' risks and responsibilities

As the economic climate remains uncertain it is important that directors take care to ensure that their actions do not result in difficulties for them if their company should become insolvent.

When a company goes into liquidation the action or inaction of the directors leading up to the insolvency will be the subject of investigation by the liquidator and perhaps also by the Office of the Director of Corporate Enforcement (the ODCE). In all cases of insolvency the directors run the risk of restriction or disqualification described below.

Restriction

If an insolvent company is wound up then, unless the Director of Corporate Enforcement (DCE) relieves the liquidator from doing so, the liquidator is obliged to apply to the High Court pursuant to section 150 of the *Companies Act 1990* for an order restricting each of the directors of the

company from acting as a director or the secretary of any other company for a period of five years unless that other company has a paid up share capital of just under €63,500. Section 150 applies to any person who was a director of the insolvent company in question, either at the date of, or within 12 months of the commencement of, its winding up. The section also applies to shadow directors.

While €63,500 is a modest amount of share capital in today's world the opprobrium attaching to a restriction order may well have more significance for the individual.


The Court is obliged to make a restriction order, unless it is satisfied that:

- (a) the individual concerned has acted honestly and responsibly in relation to the conduct of the affairs of the insolvent company, and
- (b) there is no other reason why it would be just and equitable that he should be subject to a restriction order.

The burden of proof is on the director, to satisfy the court that he has acted honestly and responsibly in relation to the conduct of the affairs of the company and that there is no other reason why it would be just and equitable that such an order should be made against him.

The seminal case is *La Moselle Clothing Limited (1998)*. In that case the court indicated that in determining the 'responsibility' of a director for the purposes of section 150, the Court should have regard to the following:

1. the extent to which the director has or has not complied with any obligation imposed on him by the Companies Acts;
2. the extent to which his conduct could be regarded as so incompetent as to amount to irresponsibility;
3. the extent of the director's responsibility for the insolvency of the company;
4. the extent of the director's responsibility for the net deficiency in the assets of the



company disclosed at the date of the winding up or thereafter; and,

5. the extent to which the director in his conduct of the affairs of the company has displayed a lack of commercial probity or want of proper standards.

In *Re Squash (Ireland) Limited (2001)*, the Supreme Court approved the test set out in *La Moselle Clothing Limited*. The Supreme Court also held that in scrutinising the conduct of any director, the court should look at the entire tenure of his directorship, and not only in the months in the run up to the liquidation.

The DCE has made clear that he will only consider relieving a liquidator from his obligation to seek a restriction order where the liquidator advances a coherent justification in respect of a claim that the director has acted honestly and reasonably in conducting the company's affairs.

According to the annual report of the ODCE for 2006, in that year liquidators made 319 reports to the DCE. The DCE relieved the liquidator of the obligation to seek a disqualification in 190 cases, denied relief in 40 cases, granted relief 'at this time' in 78 cases and granted partial relief in 10 cases.

Where relief was granted 'at this time' the liquidator was given further time to investigate the affairs of the company following which a further report would be required and the DCE would then make a decision. Where partial relief was granted the

DCE was satisfied that some but not all of the directors had acted honestly and responsibly and a restriction order would have been sought against those in respect of whom the DCE was not satisfied that they acted honestly and responsibly.

What the ODCE annual report indicates is that in 40% of the cases reported to the DCE directors had to contend with further investigation which might result in a court hearing or had to contend with a court hearing.

Disqualification from acting as a director

Section 160(1) of the 1990 Act provides for automatic disqualification from acting as an auditor, director, other officer, receiver, liquidator or examiner, where a person is convicted on indictment of any indictable offence in relation to a company or involving fraud or dishonesty, for a period of five years or such other period as the court may order.

Disqualification orders were made against nine directors of insolvent companies in 2006.

Costs

Even where a director succeeds in avoiding a restriction or disqualification order the costs incurred by the directors in dealing with the liquidator's enquiries and if necessary in being heard on an application for restriction or disqualification can be considerable. It is not the practise of the High Court to award costs against the liquidator where a restriction or disqualification order is not made.

Matters which may give rise to restriction, disqualification and personal liability for debts of the company

In an insolvency the matters which will most often arise for consideration are:

- alleged fraudulent trading;
- alleged reckless trading;
- alleged fraudulent preference of a creditor; and
- alleged failure to keep proper books of account of the company.

Fraudulent trading


A person can suffer civil liability and criminal liability for fraudulent trading.

If in the course of a winding up of a company, or in the course of a company being in examinership, it appears that any person was knowingly a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, then the court may declare that such person shall be personally responsible for all or any part of the debts or other liabilities of the company.

The concept of fraudulence denotes actual dishonesty. Tax evasion, failure to make payments into an employee pension scheme, maintaining separate books of account, diverting monies payable to the company to a director or shareholder, incurring credit at a time when to the knowledge of the director there is no prospect of that credit being repayable, would all constitute fraudulent trading.

¹ : That is, initial reports where no prior report had been made to the DCE

^{2,3} : Annual Report of the ODCE for 2006



The offence is knowingly being a party to the carrying on of the business of the company with intent to defraud. Proving intent can be difficult as it is a subjective test of the mindset of the director at the time. The question of liability for fraudulent trading is one which must be considered in the case of each individual. A person can not be held to be knowingly a party to carrying on business with intent to defraud merely because he is one of the directors of the company. He must be party to the actual impugned event.

It is also important to bear in mind that where there is an allegation of fraudulent trading it is not just the directors of the company who may be visited with liability. Any person knowingly a party to fraudulent trading can be held liable. Thus for example, persons who fraudulently receive assets from a company which is insolvent could themselves be held liable for fraudulent trading as could employees party to the impugned acts.

It is nonetheless not always easy to succeed in making somebody liable for fraudulent trading because of the difficulty of proving intent.

Reckless trading

Because of this difficulty Irish company law also has a concept of reckless trading. If in the course of the winding up of a company or in the course of examinership proceedings it appears that any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless

manner, the court may declare that the person shall be personally liable for all or any part of the debts or other liabilities of the company.

The Companies Acts provide that an officer of a company shall be deemed to be knowingly a party to the carrying on of any business of the company in a reckless manner if:

- (a) he was a party to the carrying on of such business and having regard to the general knowledge, skill and experience that might reasonably be expected of a person in his position he ought to have known that his actions or those of the company would cause loss to the creditors of the company or any of them, or
- (b) he was a party to the contracting of a debt by the company and did not honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as pay all of its other debts (contingent and prospective debts included).

The test to be satisfied to prove an officer was party to reckless trading has an element of objectivity and subjectivity. It is a question of objective fact what might be reasonably be expected in terms of knowledge, skill and experience of a person in his position. A certain level of competence, knowledge and experience of cashflows and credit risk would for example be expected of some person who was acting as a finance director, which would not be expected of some person who is a director responsible for human resources.


In the leading case in this area ***Re Hefferon Kearns Limited***, the High Court held that:

‘inclusion of the word ‘knowingly’ requires that the director is party to carrying on the business in a manner which the director knows very well involves an obvious and serious risk of loss or damage to others yet ignores that risk because he does not care whether such others suffer loss or damage or because his selfish desire to keep his own company alive overrides any concern which he ought to have for others’.

A director will not be deemed to be knowingly a party to reckless trading simply because he was aware of reckless conduct on the part of other officers. The actions of each officer must be looked at separately. However, an officer who decides to take no part in the affairs of the company may not escape liability because to refrain from exercising proper control or input may amount to recklessness.

Mindful perhaps of the pressures on directors in difficult times, the courts have indicated that they will not find that directors are responsible for reckless trading because they do not shut up shop at the first sign of danger. In the Hefferon Kearns case it was said that:

‘it would not be in the interests of the community that whenever there might be any significant danger that the company was going to be insolvent the directors should immediately cease trading and close down the business.



Many businesses which might well have survived by continuing to trade coupled with remedial remedies could be lost to the community [if they were to close down].'

Monitoring the affairs of the company

What the cases demonstrate is the need for the directors to pay close and frequent attention to the financial performance of the company in difficult times. Financial reporting needs to be carefully reviewed. The directors need to be satisfied that the frequency with which they receive reports is sufficient to enable them at all times to be in a position to make an informed assessment of the business and prospects of the company.

Where monthly reports might suffice in a benign climate, in more difficult times it may be that reports should be weekly or even daily.

The directors also need to take great care to fully consider incurring liability at such time, particularly in respect of any new activity. In some cases a company will be engaged in a project and careful consideration of all relevant facts may give sufficient support for continuing to trade with a view to profitably completing the matter. For this purpose the directors would need to review the assets and liabilities of the company, the cashflow of the company and then they should be in a position to reach a decision whether to continue with the project.

Fraudulent preference

Fraudulent preference is the wrongful favouring of one creditor over others. Any such activity undertaken by a company which is unable to pay its debts is deemed to be a fraudulent preference and is invalid. If a company is put into liquidation, any such preference undertaken in the prior six months can be set aside as a fraudulent preference. Where a creditor is a director of the company or connected with a director the look back period is extended to the two years prior to the winding up. It is important to understand that payment to a creditor will only be impugned as fraudulent if there is a degree of preference. Payment to a creditor who has been very diligent about pursuing his debt will not amount to fraudulent preference as there will not have been an intention to prefer that creditor but rather an acceptance that a debt is due and that the particular creditor has been diligent in seeking payment. Among the types of payments which a liquidator is likely to closely scrutinise are repayments of borrowings where directors or shareholders have given a personal guarantee of those borrowings and will be personally liable if the company should fail.

Necessity to keep proper books of account

The Companies Acts also provide that if an insolvent company is being wound up and there has been a failure to keep proper books of account then the court may if it considers that the failure has contributed to the company's

inability to pay all of its debts, or has resulted in substantial uncertainty as to the assets and liabilities of the company or has substantially impeded the orderly winding up of the company, find every officer of the company who is responsible for the failure guilty of an offence. A fine of up to €12,700 or imprisonment for a term not exceeding five years or both imprisonment and fine could be imposed.

Apart from the criminal liability for failure to keep proper books of account the court may also on the application of any liquidator or creditor of the company declare that any of the officers, or former officers, who is or who were in default and responsible for the failure shall be personally liable for the debts and obligations of the company. The Companies Act has expressly made clear that an officer can be held criminally liable for failure to keep proper books of account and also have personal liability for the debts and obligations of the company.

Summary

While the foregoing may seem daunting, it is important to keep in mind that the courts are mindful that directors do have to operate in difficult situations and that it is not always in the best interests of a company, its creditors or the community at large that a company immediately cease trading whenever there might appear to be any significant danger that the company would become insolvent. There will be many cases where an appropriate decision can be reached that it is better to continue to trade

because there are reasonable grounds for believing that the company can trade out of its difficulties.

What is critically important is for the directors to be vigilant and to be diligent in ensuring that they have comprehensive and timely information about the affairs of the company and that they continue to keep its performance under review. It would also be prudent to ensure that board meetings are properly convened, held and minuted and to ensure that the directors seek professional advice in advance of any significant decisions.



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