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Research Briefing

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Directors' responsibilities during insolvency

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Summary

A company is insolvent if it can't pay its debts.

Insolvency proceedings are processes an insolvent company goes through to try and deal with its debts. There are two main types of insolvency proceedings: some try to rescue the company, while others close the company down.

Directors' duties

Directors are responsible for the day-to-day management of companies. Their role is set out in company law, the company's constitution (Articles of Association) and, if they are also employees, their employment contracts.

Directors owe legal duties. An important one is the duty to promote the success of the company for the benefit of its shareholders. But when a company is in financial difficulty and there is a risk of insolvency, directors owe a duty to creditors (people owed money) to minimise their losses.

Responsibility for mismanagement

A company is a separate legal entity from its directors, so a director can't normally be personally sued for debts of a company. But if directors have mismanaged a company that becomes insolvent, they can be personally responsible in certain situations:

- **Wrongful trading** happens when directors carry on trading after there is no reasonable prospect of a company avoiding liquidation (being closed down). It could happen when directors still have hope of saving the company so continue trading beyond the point when they should. A court can order that a director committing wrongful trading be personally responsible for a company's debts.
- **Fraudulent trading** happens when directors have managed a now-insolvent company with the intention of defrauding creditors, for example paying themselves a salary they know the company can't afford. In addition to this being a criminal offence, a court can order that a director be personally liable to make a payment to the company.
- Directors who breach duties they owe (for example, by misusing company property) can be personally liable for **misfeasance**. This covers

things like unauthorised loans or payments to directors. In such cases a court can order a director to repay misused money to the company.

The person overseeing a company insolvency (for example the liquidator or administrator) must submit a report about the directors to the Secretary of State (in practice, the Insolvency Service) covering the last three years of trading, within three months of the company's insolvency.

The Insolvency Service will then decide whether to investigate further and apply to court for a disqualification order of up to 15 years against a director. A disqualified director must not act as a company director or be involved with the formation, marketing or running of a new company. As an alternative to an order, the Secretary of State may accept a voluntary disqualification undertaking from a director. This can save time and avoid court costs.

Reforms

The Department for Business, Energy and Industrial Strategy has consulted on proposals to improve the UK's corporate governance and insolvency framework. Our Library briefing paper Corporate insolvency framework: proposed major reforms has more detail.

Our Library briefing paper New business support measures: Corporate Insolvency and Governance Act 2020, gives more detail on recent reforms to the UK insolvency regime and temporary modifications to it during the COVID-19 pandemic.

Corporate insolvency legislation generally applies across England, Wales and Scotland.

1 Introduction to insolvency

A company is insolvent if it can't pay its debts.

Insolvency procedures (or proceedings) are processes an insolvent company goes through to try and deal with its debts. There are two main types of insolvency procedures:

Liquidation procedures

These focus on winding-down (stopping) any ongoing business, realising (selling off) assets and returning money obtained from that process to creditors (people owed money). There are two main types of liquidation procedures:

- **Compulsory liquidation**. This is when someone (usually a creditor) asks a court to order that the company be closed down, usually on the basis that it is insolvent. See our briefing Compulsory liquidation of a company for more detail.
- **Voluntary liquidation**. This is when the company's members (shareholders) vote by a 75% majority[1] to liquidate the company. It can happen when a company is insolvent (known as Creditors' Voluntary Liquidation) or solvent (known as Members' Voluntary Liquidation).

Rescue procedures

These try and deal with the insolvent company's debts while allowing for the company to survive. There are four main types[2] of rescue procedures:

- **Administration**. This places the insolvent company under the control of a qualified insolvency practitioner (IP), whose first objective is to rescue the company so that it can continue trading. If that is impossible, the administrator's objective is to achieve a better result for the company's creditors than if the company were put into liquidation. To assist the administrator, a moratorium (block) is put in place. This prohibits creditors from pursuing the company while it is in administration. Our briefing Insolvency: company administration has more detail.
- **Company voluntary arrangement** (CVA). This is an agreement between a company in financial difficulty and its creditors. Its purpose is to avoid

[1] See section 84(1) of the Insolvency Act 1986

[2] Two related measures not mentioned here are the statutory moratorium introduced by the Corporate Insolvency and Governance Act 2020, and administrative receivership

liquidation. Typically, a CVA will include rescheduling or reducing the company's debts. A CVA is implemented by an IP and must be approved by creditors. Our briefing Company Voluntary Arrangements has more detail.

- **Scheme of arrangement**. This is an arrangement between a company and its members or creditors. Unlike a CVA it must be sanctioned by a court as well as creditors. When sanctioned, the scheme binds all members and creditors regardless of whether they had notice of the arrangement.
- **Restructuring plan.** The Corporate Insolvency and Governance Act 2020 introduced a new restructuring plan procedure. Courts can sanction a restructuring plan (that binds creditors) if it is "fair and equitable". Creditors vote on the plan, but the court can impose it on dissenting creditors. Unlike a CVA, it can bind secured creditors (like a bank with a mortgage over land). Section 2.3 of our Corporate Insolvency and Governance Act 2020 briefing has more detail.

2 The duties of directors

2.1 Solvent companies

A company is a separate legal entity from its directors, but the directors are responsible for managing the company and exercising all its powers. For example, directors must ensure that the company files accounts and reports at Companies House.[3]

Directors' powers can be restricted by the company's constitution ("Articles of Association") or company law. For example, Articles of Association often include restrictions on borrowing. The Articles may entitle the board to delegate powers to individual directors.

The Companies Act 2006[4] sets out seven general duties of directors:

1. To act within powers in accordance with the company's constitution and to use those powers only for the purpose for which they were conferred
2. To promote the success of the company for the benefit of its members (shareholders)
3. To exercise independent judgement
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts of interest
6. Not to accept benefits from third parties
7. To declare an interest in a proposed transaction or arrangement

2.2 Insolvent companies

When a liquidator is appointed, directors lose their powers - they cannot access the company's bank account or run the company.[5] In an administration, directors can't exercise management powers without the consent of the administrator.[6]

In other cases or procedures, directors should be aware that when a company becomes insolvent, their duty under the Companies Act 2006 to promote the

3 Section 441 of the Companies Act 2006 (CA)
4 Section 171 to 177 CA
5 See The Gazette, A guide to liquidation, updated 24 May 2021
6 Paragraph 64, Schedule B1, Insolvency Act 1986

success of the company for the benefit of its shareholders is displaced (replaced) by a duty to minimise losses to creditors.[7]

If they breach this duty, they may commit a criminal offence or be personally liable to make up shortfalls to creditors (as discussed below).

7 Section 172(3), and para 331 of the Explanatory Notes, for the CA

3 When can a director be personally liable?

Legally, nothing prevents a director of an insolvent company from starting another new business that does the same thing,overnight,. But if they have acted in breach of their duties to creditors of the insolvent company, they can be sued for wrongful or fraudulent trading, or misfeasance.

3.1 Wrongful trading

Wrongful trading happens when directors carry on trading after there is no reasonable prospect of a company avoiding liquidation. It happens when directors still have hope of saving the company so continue trading beyond the point when they should.

A court (on the application of a liquidator[8]) can order that a director be personally responsible for a company's debts if:

> ...at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.[9]

Dishonesty is not required. There only needs to be evidence of:

(i) the director's wrongful trading; and

(ii) that the wrongful trading resulted in losses to creditors.

The court will consider a range of evidence in deciding whether the director should have known that the company could not reasonably have avoided liquidation, such as creditors being paid late, targets being missed, and the potential future opportunities which were available at the time.[10]

However, there is a defence. A court will not make an order for wrongful trading if the director took every step to minimise loss to creditors that they should have taken.[11]

8 Or, in the case of an administration, the administrator: section 246(ZB) of the IA 1986
9 Sections 214(2)(b) of the IA 1986
10 See for example the judgement in the case of Mond v Bowles (October 2011)
11 Sections 214(3) and 246ZB(3) of the IA 1986

During the coronavirus pandemic, the Government suspended the wrongful trading rules from 1 March 2020 to 30 September 2020 and again from 26 November 2020 to 30 June 2021. This was to relieve pressure on directors to close viable businesses to avoid personal liability for wrongful trading. Section 3.1 of our Corporate Insolvency and Governance Act 2020 briefing discusses this in more detail.

3.2 Fraudulent trading

If during their work a liquidator or administrator thinks that the directors have managed the company with the intention of defrauding creditors, they can ask a court to order those directors to be personally liable to make a payment to the company that it thinks appropriate.[12]

There must be "actual dishonesty, involving [...] real moral blame".[13] This might include for example directors paying themselves a large salary they know the company can't afford, or taking out debts they know can't be paid back.

Unlike wrongful trading, if this is proved then the director will, in addition to having to contribute to the company, be guilty of a criminal offence punishable by up to ten years' imprisonment.[14]

3.3 Misfeasance or breach of fiduciary duty

Directors who breach duties they owe (for example, by misusing company property) can be personally liable. This will cover things like improper payments of dividends, using money for an improper purpose, using money contrary to the Companies Acts, or unauthorised loans or payments to its directors.

In such cases persons including the liquidator, administrator or creditors can apply for a court order to require a director repays misused money to the company.[15]

3.4 Other criminal offences

Other offences relevant to directors of insolvent companies are:

[12] Sections 213 and 246ZA, Insolvency Act 1986 – **section 246ZA** came into force on 1 October 2015
[13] Re Patrick and Lyon Ltd [1933] Ch 786
[14] Section 993 of the CA 2006
[15] See section 212 of the IA

- Fraud in anticipation of winding up of the company
- Transactions in fraud of creditors
- Misconduct in the course of winding up
- Falsification of company's books
- Material omissions from statements relating to the company's affairs
- False representations to creditors.[16]

[16] See sections 206 to 211 of the IA

4 Director disqualification

4.1 Duty to report

The person overseeing the insolvency (for example the liquidator or administrator) must submit a report about the directors to the Secretary of State (in practice, to the Insolvency Service) covering the last three years of trading, within three months of the company's insolvency.[17] This is now done online using the Director Conduct Reporting Service.

The Insolvency Service will then decide whether to investigate further and seek a disqualification order against a director.[18]

4.2 Disqualification orders

The Secretary of State (the Insolvency Service) can apply to court for a disqualification order of up to 15 years against a director.[19]

Examples of conduct which may lead to disqualification include:

- continuing to trade to the detriment of creditors at a time when the company was insolvent
- failure to keep proper accounting records
- failure to prepare and file accounts or make returns to Companies House
- failure to submit tax returns or pay tax or other money due
- failure to co-operate with the Official receiver/insolvency practitioner.[20]

A disqualified person must not act as a company director or be involved with the formation, marketing or running of a new company.[21] But they can carry on business as a sole trader or partner in an unlimited liability partnership.

[17] Section 7A of the Company Directors Disqualification Act 1986

[18] Section 9, "Company Directors Disqualification Act 1986 and Failed Companies: A Guide to Director Disqualification"

[19] Ibid, section 1

[20] Ibid, section 5

[21] Ibid, section 3

It is a criminal offence to breach a disqualification order, punishable by up to two years' imprisonment. A disqualified director can also become personally liable for company debts incurred while the order is breached.[22]

As an alternative to an order, the Secretary of State may accept a voluntary disqualification undertaking from a director. This saves time and avoids court costs. Breaching the undertaking has the same consequences breaching an order.[23]

4.3 Reporting a disqualified director

Information about a director breaching a disqualification order or undertaking can be passed on to the Insolvency Service using a dedicated website.

Anyone can search the Disqualified Directors Register to check the names of disqualified directors. The register also indicates if a disqualified director has obtained special court permission to manage certain companies.

[22] Ibid, section 5

[23] See section 1A of the CDDA 1986

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