



BRIEFING PAPER

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Phoenix trading and liability of directors

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Summary

Constituents frequently raise with their Members of Parliament the issue of phoenix trading and pre-pack administrations.

What is phoenix trading?

- This is where the assets of an insolvent business are re-acquired (often at less than their full value) by its former directors (or closely connected parties) who then set-up a new company involved in the same or similar business.
- This new company is referred to as a 'phoenix company' or a 'newco'.
- Phoenix trading is often linked to pre-packaged administrations (referred to as 'pre-packs').

What is pre-pack administration?

- A 'pre-pack' is an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of the administrator, and the sale contract executed on the appointment of the administrator or very shortly afterwards.
- Pre-packs are not specifically provided for in insolvency legislation; according to the Insolvency Service, they have arisen out of practice and through judicial approval.

Some creditors who are owed money by a failed company are often outraged to find that the directors of these companies may suffer little personal loss and are often able to start up a new business in the same field. To a certain extent this is an inevitable consequence of corporate 'limited liability'. For the purposes of the law, a company is a separate legal entity and if it trades with limited liability its directors and shareholders do not usually retain liability for the company's debts should it become insolvent.

Legally, there is nothing in law to prevent a director of a failed company from starting a new business 'overnight' provided that he has acted 'properly' in managing the first company both before and during its insolvency. However, if the director of an insolvent company has deliberately acted to the detriment of creditors, action may be taken against him under both insolvency and company legislation. In certain circumstances, directors may incur personal liability for their acts or omissions in managing the company.

This Library briefing paper looks in detail at the legality of phoenix trading and at the personal liability of directors to the creditors of an insolvent company. In addition to the [Insolvency Act 1986](#) (as amended) and the [Enterprise Act 2002](#), this note looks at new provisions contained in the [Small Business Enterprise and Employment Act 2015](#), which received Royal Assent on 26 March 2015.

1. What is phoenix trading?

Box 1: Definition of 'phoenixism'

'Phoenixism' is the name popularly given to those situations where the assets of an insolvent business are re-acquired by its former management or closely connected parties to form a phoenix company or 'newco'. Often some or all of the directors remain the same and in some cases, the phoenix company has the same name or a similar name to the failed business. The phoenix company will operate in the same area as its predecessor.

For the purposes of the law, a company is a separate legal entity and if it trades with limited liability its directors and shareholders do not usually retain liability for the company's debts should it become insolvent. It is not illegal for directors of an insolvent company to form a new company from the remnants of the failed company, and they can become new directors except in circumstances where he or she is:

- subject to a disqualification order or undertaking;
- personally adjudged bankrupt; or
- subject to a bankruptcy restrictions order or undertaking

The phoenix company arrangement allows a business to start again and for the profitable elements of the failed business to survive, offering some continuity for both suppliers and employees.

The majority of phoenix companies (or 'newcos') are legitimate businesses. Not all businesses succeed at the first attempt; businesses can fail for any number of reasons. In a minority of cases, there may be concerns that some directors have deliberately forced their company into insolvency in order to 'buy back' business assets at a reduced price (thereby reducing the funds available to creditors) while avoiding their responsibility for the debts of the company. However, the [Insolvency Act 1986](#) (the 'IA 1986') (as amended) has made it far more difficult for directors to do this, with stricter rules over the insolvency process (see below).

Creditors are often aggrieved to find that the directors of an insolvent company may suffer little personal loss and are often able to start up a new business in the same field.

To a certain extent this is an inevitable consequence of corporate limited liability.

2. Is phoenix trading legal?

It is not illegal to start up a phoenix company following the liquidation of the original company, but there are rules to be followed. The rules are designed to prevent directors deliberately running a company into liquidation, leaving unpaid creditors, only to set up 'over-night' a new business trading under a similar name to that of the liquidated company. The rules outlined below apply to anyone who was a director or shadow director of a company in the 12 months ending with the day before it went into insolvent liquidation.¹

It is not illegal to start up a phoenix company - but there are rules.

It is important to note that the insolvency practitioner, appointed as 'liquidator' by the court to manage the affairs of an insolvent company, has a duty under the IA 1986 to investigate the causes of the company's failure. The [Insolvency Service](#) may also investigate a failed company (and the role of its directors) where there are concerns about either the trading practices of the company or the circumstances surrounding the failure of successive companies.

2.1 Restrictions on use of company name

A phoenix company may not use any name by which the liquidating company was known in the last 12 months or a name which is so similar that it suggests an association with the liquidated company. The only exception is if there is an arrangement with the liquidator to acquire substantially the whole of the business of the insolvent company or the new company with the similar name has been known as such for 12 months prior to the creditors meeting of the liquidated company and has not been dormant.

Use of the liquidating company's name

In addition, the IA 1986 makes it an offence for a director of a company which has gone into insolvent liquidation to be a director of a company with the same or a similar name, or concerned in its management, without the leave (i.e. permission) of the court within 5 years after the winding up (see **Box 2** below).

¹ The term 'director' applies to anyone in the position of a director of a company, whether they are called a director or not. It includes those who give instructions on which the directors or a company are accustomed to act.

Box 2: What is the offence under section 216 of the IA 1986?

Section 216 of the IA 1986 is designed to protect the public from being misled into dealing with a new business, thinking that it is still the liquidated company. A person may be caught by section 216 if they were a director or shadow director of the company at any time within the 12 months before the liquidation of the company.

Section 216 creates a criminal offence of re-using a company name where a company has gone into insolvent liquidation. The offence is widely drafted and is one of **strict liability** and will be committed unless a person can prove that he comes within one of three limited exceptions. (These exceptions are found in rules 4.226 to 4.230 of the Insolvency Rules 1986.)

Infringement of section 216 can lead to :

- A fine or imprisonment
- Confiscation proceedings to seize any benefit obtained while infringing this section
- Disqualification from acting as a company director
- A personal liability under section 217 of the IA 1986 for all debts incurred during the infringement

2.2 Legitimate sale of company assets

If a director of an insolvent company wishes to sell assets to a new company (to which he is connected) he is expected to obtain a proper independent valuation of company assets before sale. In addition to the insolvent company's tangible assets (e.g. machinery, raw materials, buildings etc.) its intellectual property and goodwill should also be independently valued. The physical assets of the company can be valued on three bases:

- forced sale – an estimate of the expected realisable value of the assets if they are sold quickly at auction;
- open market sale- the expected realisable value of the assets if they are not sold quickly; and
- value to the business

To avoid any challenges as to the legitimacy of property transactions to 'connected parties', the asset(s) should properly be sold at the higher of the above valuations.

The need for an independent valuation of company assets.

2.3 Transactions that may be set aside

In extreme cases, there may be grounds for having disposal of company assets transactions set aside (i.e. cancelled) by the court on the grounds that they are preference transactions or transactions at an undervalue, provided the transactions were entered into at a time when the company was unable to pay its debts (see **Boxes 3** and **4** below). In effect, the liquidator is able to begin a recovery action on behalf of the creditors.

Box 3: Preference transactions - section 239(4) of the IA 1986

Section 239(4) of the IA 1986 provides that a preference is given if:

- (a) a person is one of the company's creditors; and
- (b) the company does anything, or suffers anything to be done, which has the effect of putting that person into a position which, in the event of the company going into insolvency, will be better than the position he would have been in had the transaction not been done.

Box 4: Transactions at an undervalue – section 238 of the IA 1986:

A transaction between a company and a person at an undervalue, as defined by Section 238 of the IA 1986, is made if:

- (a) a company makes a gift to that person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or
- (b) the company enters into a transaction with that person for a consideration the true value of which is significantly less than the value of the consideration provided by the company.

An example of a transaction at an undervalue would be if the director of an insolvent company sold assets at a fraction of their true value to another company owned by his son. An application could be made to the Court to have the transaction set aside as a transaction at an 'undervalue'; the assets involved would instead be used for the benefit of the creditors.

3. Phoenix trading and pre-packs

Phoenix trading is sometimes linked to pre-packaged administration (a pre-pack). A pre-pack is an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of the administrator, and the sale contract executed on the appointment of the administrator or very shortly afterwards (see **Box 5**).

Box 5: Characteristics of pre-pack administrations

- The term 'pre-pack' is used in the context of administration. It describes any situation where the business of an insolvent company is prepared for sale to a selected buyer (i.e. 'pre-packaged') prior to the company's entry into formal insolvency proceedings. The agreed sale is then carried out by the administrator, an authorised insolvency practitioner, shortly following their appointment.
- Often a pre-pack involves the sale of a company's business on a 'going concern' basis. However, sometimes a pre-pack will just involve the sale of some or all of the assets of a company. The rest of the company's assets or the business may be sold off in a separate transaction, or the company put into liquidation.
- The key attraction to the use of pre-packs is the speed with which the administration proceeds.
- Pre-packs are not a new restructuring strategy but their use has grown substantially over recent years.
- The Insolvency Service has estimated that 25 per cent of the 2,808 companies that entered administration in 2011 used the pre-pack procedure; and that nearly 80 per cent of pre-pack sales were to connected parties.²

When undertaken in appropriate circumstances, pre pack administration is a procedure by which a potentially successful business can be saved (with the value of its brand in tact), protecting jobs.

However, pre-packs have been criticised for both their lack of accountability and transparency. The IA 1986 does not expressly provide for pre-packs and the decision to execute a pre-pack sale is a matter for the commercial judgment of the administrator. Unsecured creditors often do not realise that a pre-pack sale is going to happen and so have no opportunity to protect their interests by considering and voting on the pre-pack proposal. Consequently, the administrator can sell company assets before his proposals have been agreed by creditors and without court sanction.³ (By contrast, secured creditors are usually involved, because they need to consent to the release of their security where secured assets are to be included in the sale).

The worry of some unsecured creditors is that company assets may have been sold at a reduced price, or that the 'goodwill' of the business may not have been properly valued because of the speed of the sale. The matter is further complicated if the purchaser is the existing management, with concerns raised as to the potential for abuse of the

² The Insolvency Service, 'Annual Report on the Operation of Statement of Insolvency Practice 16', January/ December 2011

³ DKLL Solicitors v HMRC [2007] EWHC 2067 (Ch)

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process by directors seeking to purchase a business at an advantageous price and simply avoid payment of creditors.

To address these concerns, [Statement of Insolvency Practice \(SIP 16\)](#) was first issued in January 2009 and subsequently updated, most recently on 1 November 2015. SIP 16 aims to address creditor concerns about pre-packs by making the process more transparent, including by providing creditors with information about the marketing of the business and the alternatives considered. It sets out the standards that the administrator must adhere to, and includes the information that the administrator should disclose to creditors within 7 days of completing the pre-pack sale (see section 6 below).

4. Changes to pre-pack administrations

4.1 Compliance with the latest Statement of Insolvency Practice 16(SIP 16)

Since the 1 November 2015, insolvency practitioners have been required to comply with the latest [Statement of Insolvency Practice \(SIP 16\)](#) in connection with pre-pack administrations. The main changes to SIP 16 have been in the area of marketing (see **Box 6**).

Although SIP 16 is not legally binding, failure to comply with it could result in an administrator facing regulatory or disciplinary action.⁴ The Insolvency Service used to have responsibility for monitoring compliance with SIP 16, but that responsibility now lies with the individual insolvency practitioner's own regulatory body.

Box 6: Statement of Insolvency Practice (SIP 16)

Since the 1 November 2015, insolvency practitioners have been required to comply with the latest Statement of Insolvency Practice ([SIP 16](#)) in connection with pre-pack administrations.

SIP 16 sets out the 'marketing essentials' these essentials include:

- Broadcast – the business must be marketed as widely as possible.
- Justification of the strategy – explain the marketing and media strategy.
- Independence – ensure that they are satisfied as to the adequacy and independence of the strategy adopted in the marketing process, particularly important where marketing is taking place before the appointment takes effect.
- Publicise rather than just publishing – marketing should be over an appropriate length of time.
- Connectivity – include the use of online media alongside other marketing by default.
- Comply or explain – particularly where the sale is to a connected party with high levels of interest, an explanation needs to be given as to how the marketing strategy achieved the best result for creditors as a whole in all the circumstances.

Taken together, the administrator is required to carry out more transparent marketing of the business prior to the sale.

⁴ The High Court has held that the failure of administrators to comply with SIP 16 was not in itself a ground to remove them from office, see [Clydesdale Financial Services Ltd and others v Smailes](#) [2009] EWHC 1745 (Ch)

4.2 Creation of the Pre-Pack Pool

The House of Commons Business, Innovation and Skills (BIS) Select Committee sixth report on '[The Insolvency Service](#)' was published on 6 February 2013.⁵ In respect of pre-pack administrations, and a possible link to phoenix companies, the Select Committee concluded that they remain a controversial practice:

80. In May 2009, our predecessor Committee expressed concerns about the lack of transparency, resultant abuse of pre-pack administrations and their link to 'phoenix companies'. Despite the introduction of Statement of Insolvency Practice Note 16 and additional guidance, pre-pack administrations remain a controversial practice. The Insolvency Service is committed to continue to monitor SIP 16 compliance, but to make this effective, non-compliance needs to be followed through with stronger penalties by way of larger fines and stronger measures of enforcement.⁶

The Committee made a number of recommendations, including the commission of research to renew the evidential basis for pre-pack administrations.

In July 2013, Vince Cable, then Business Secretary, announced the appointment of Teresa Graham CBE to undertake an independent review of pre-pack procedure. This followed a speech he gave on the issue of transparency and trust in business.⁷

On 16 June 2014, the '[Graham Review into Pre-pack Administration](#)'⁸ was duly published together with a report on pre-pack empirical research, '[Characteristic and Outcome Analysis of Pre-pack Administration](#)'.⁹ The report proposed voluntary scrutiny of pre-pack deals rather than new legislation. It made 6 key recommendations, particularly targeted at sales to 'connected parties'. Its research had shown that creditor pay-outs were often worse and the new business was less likely to succeed following these kind of pre-pack deals.¹⁰ Jenny

⁵ House of Commons Business, Innovation and Skills Committee, "[The Insolvency Service](#)", Sixth Report of Session 2012-13, Evidence 67, 29 January 2013 [online] (accessed 9 September 2014)

⁶ Ibid

⁷ This review of pre-packs was part of a wider Government programme to improve corporate transparency. See Department for Business, Innovation and Skills, '[Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business – Discussion Paper](#)' July 2013, [online] (accessed 2 September 2014)

⁸ "[Graham Review into Pre-pack Administration – Report to The Rt. Hon. Vince Cable MP](#)", Teresa Graham CBE, June 2014, [online] (accessed 2 September 2014)

⁹ "[Pre-pack Empirical research: Characteristic and Outcome Analysis of Pre-pack Administration – Final Report to the Graham Review](#)", prepared by Professor Peter Walton and Chris Umfreville with the assistance of Dr Paul Wilson, University of Wolverhampton, April 2014, [online] (accessed 2 September 2014)

¹⁰ "[Pre-pack Empirical research: Characteristic and Outcome Analysis of Pre-pack Administration – Final Report to the Graham Review](#)", prepared by Professor Peter Walton and Chris Umfreville with the assistance of Dr Paul Wilson, University of Wolverhampton, April 2014, [online] (accessed 2 September 2014)

Willott, then Business Minister, said that the Government supported the voluntary approach set out in the Graham report.¹¹

One of the key recommendations of the Graham report was that a pool of independent business people be set up in order to assess and give an opinion upon a proposed pre-pack sale to a 'connected person'. This recommendation was adopted, and a [Pre-Pack Pool](#) came into force on **2 November 2015**. Insolvency Practitioners now need to make 'connected party' purchasers aware of this pool, which operates exclusively online (see **Box 7**).

The process of using the Pre-Pack Pool is not compulsory, but it is considered best practice. It helps to ensure transparency for creditors.

Box 7: The new Pre-Pack Pool

Since 2 November 2015, if a 'connected party' wishes to purchase a business that is about to go into administration, then it is recommended that they approach the [Pre-Pack Pool](#), who will independently review the proposed deal prior to it being completed. Applications to the Pre-Pack Pool are submitted via an on-line portal (there is a fee).

Such a recommendation applies only to purchasers who are deemed to be a 'connected party'. A 'connected party' can be a director, shadow director or owner of an insolvent company, or an associate of these parties who then becomes the director, shadow director or owner of the new company.

The application is considered by one Pre-Pack Pool reviewer, who can give one of three outcomes (usually within 48 hours, so to minimise any disruption) :

- the pre-pack purchase is not unreasonable; or
- the pre-pack purchase is not unreasonable, but there are minor limitations in the evidence provided; or
- the case for pre-pack has not been made out

A copy of the reviewer's opinion is attached to the administrator's SIP 16 report, which is then sent to creditors. A pre-pack deal can still go ahead, even if a negative statement is received from the pool of experts. However, the administrator would need to set out the reasons for doing so in the SIP 16 report to creditors.

It is important to note that referral to the Pre-Pack Pool by a connected purchaser is only voluntary. However, the administrator's SIP 16 report to creditors will be expected to disclose the reasons why the connected party decided not to approach the pool for sanction.

Obviously, the main aim of this voluntary scrutiny is to create confidence and transparency in a proposed deal to a connected party for the benefit of the creditors. The purchaser may also provide a voluntary viability review statement (see below).

This reform has also been reinforced by a revised [\(SIP\) 16](#) which strengthens the requirements for marketing and independent valuation in pre-pack administration deals.

¹¹ Department for Business, Innovation and Skills press notice, "[Willott announces plans to clean up 'pre-pack' insolvency deals](#)", 16 June 2014 [online] (accessed 5 September 2014)

4.3 Viability statements

Box 8: Viability Statements SIP 16

- A 'connected party' wishing to make a pre-pack purchase can draw up a viability statement essentially setting out how the purchasing entity (i.e. the business) will survive for at least the next 12 months, it is proposed that the statement should outline how things will be done differently.
- Any viability statement should be attached to the SIP 16 Statement made by the administrator.
- In the event that the statement is requested but not supplied creditors should be made aware of this in the SIP 16 Statement.
- The main aim is to create confidence and transparency in a proposed deal for the benefit of the creditors. However, it is important to note that submission of a viability statement for connected purchasers is **only voluntary**.

4.4 New reserve power: connected persons

Part 10 of the [Small Business, Enterprise and Employment Act 2015](#) ('SBEEA 2015') is concerned with pre-pack administrations and the sale of company assets to 'connected persons' (see **Box 9**). An overriding aim of the Act is to ensure that the UK continues to be a trusted and fair place to do business.

Box 9: Who is a 'connected person' for the purposes of section 129?

In a pre-pack administration, a purchasing person or company is deemed to be 'connected' if they have a relationship with the insolvent company. This includes directors, shadow directors or their associates. Section 129 also captures where common individuals exercise control over both companies.

Following the recommendation made in the [Graham Report](#),¹² **section 129** of the SBEEA 2015 creates a reserve power for the Secretary of State to make regulations in the future to either prohibit administration sales to connected parties or to impose conditions or requirements to allow a connected party administration sale to proceed.¹³ This would include connected 'pre-pack' sales. This reserve power lapses 5 years after commencement, on 26 May 2015, unless it is exercised during that period. It is envisaged that this reserve power would only be used if the voluntary measures arising from the Graham Report prove unsuccessful (see above).

¹² "[Graham Review into Pre-pack Administration – Report to The Rt. Hon. Vince Cable MP](#)", Teresa Graham CBE, June 2014, [online] (accessed 2 September 2014)

¹³ Section 129(4) of the [Small Business, Enterprise and Employment Act 2015](#)

Effectively, this reserve power leaves open the potential for more stringent reforms to be introduced by the Government should this be deemed necessary. The Insolvency Service will be monitoring progress.¹⁴

4.5 Administrators' ability to bring wrongful and fraudulent trading claims

Previously, claims under the IA 1986 for wrongful and fraudulent trading were only available to liquidators, not to administrators. In practice, this meant that a company in administration could move directly to dissolution (side stepping any intervening liquidation) without such claims having been considered by an insolvency practitioner. Alternatively, in order to pursue a wrongful or fraudulent trading claim, the administrator would first have to put the company into liquidation.

The SBEEA 2015 has changed the situation.¹⁵ Specifically, the Act inserts new sections into the IA 1986, to allow an administrator (as well as a liquidator) to bring claims against directors for fraudulent trading and wrongful trading.¹⁶ These provisions came into force on **1 October 2015**.

In effect, it is now possible for an administrator to consider potential avenues of recovery during the administration process, rather than delay any investigation until such time as the company moves from administration into liquidation (which may not occur). This should increase the potential for more claims to be brought, and more quickly, for the benefit of the creditors.

4.6 Causes of action: assignment to third parties

Following amendments to the IA 1986 made by the [SBEEA 2015](#)¹⁷ liquidators and administrators have (since **1 October 2015**) been able to assign the following rights of action to third parties:

- fraudulent trading¹⁸
- wrongful trading¹⁹
- transactions at an undervalue²⁰
- preference transactions²¹; and
- extortionate credit transactions²²

¹⁴ [The Insolvency Service](#) is an executive agency of the Department for Business Innovation and Skills (BIS)

¹⁵ Sections 117 to 119 of the [Small Business, Enterprise and Employment Act 2015](#)

¹⁶ New sections 246ZA and 246ZB to be inserted into the [Insolvency Act 1986](#) by the [Small Business, Enterprise and Employment Act 2015](#)

¹⁷ New sections 246ZD of the [Insolvency Act 1986](#)

¹⁸ Section 213 of the [Insolvency Act 1986](#)

¹⁹ Section 214 of the [Insolvency Act 1986](#)

²⁰ Section 238 of the [Insolvency Act 1986](#)

²¹ Section 239 of the [Insolvency Act 1986](#)

²² Section 244 of the [Insolvency Act 1986](#)

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In addition to conferring the ability to assign such claims, the SBEEA 2015 inserts a new section 176ZB into the IA 1986. New section 176ZB specifically provides that any proceeds recovered from any of the above listed claims (or recoveries made pursuant to an assignment of such claims) will not be treated as part of the company's net property for distribution to the holders of any floating charge created by the company.²³

Litigation is expensive and funding options are sometimes limited. It is hoped that the ability to assign such claims will ensure that fewer actions are hindered due to lack of funding which in turn will lead to more certainty and a quicker return to creditors.

²³ A floating charge is a charge on a company property that is constantly changing in value and identity (e.g. stock, book debts and work in progress). A floating charge does not attach to a specific item of property. The holder of a floating charge (e.g. a bank) has no right of possession of the assets covered by the charge until one of the events specified in the charge instrument causes the charge to 'crystallize' (e.g. a default on repayments of a loan).

5. Legal position of directors of an insolvent company

Directors owe a duty to the company and, if insolvency threatens, to creditors. Once a company has entered into formal insolvency proceedings, the official receiver, liquidator, receiver or administrator must submit to the Secretary of State a report on the conduct of all directors who were in office during the last 3 years of the company's trading.

5.1 Directors' responsibilities

The directors of a company are generally responsible for the management of the company and they may exercise all the powers of the company. However, the extent of their power may be constrained by the company's own 'Articles of Association' or by company law.²⁴ For example, Articles of Association often include provisions and restrictions on borrowing by the company. (It should be noted that companies set up since 1 October 2009 are not restricted in their objectives unless their Articles of Association say otherwise).²⁵

Articles of Association set the rules company officers must follow when running a particular company.

In general terms, the directors must act collectively as a board to bind the company. However, the Articles of Association usually entitle the board to delegate powers to individual directors as considered appropriate. In practice individual directors will normally carry out many of the company's day-to-day activities.

Directors are subject personally to statutory duties (see **Box 10** below). They must act in a way most likely to promote the success of the business and benefit its shareholders. They also have responsibilities to the company's employees and its trading partners. Directors are subject to a wide range of regulation and legislation including the *IA 1986* and the [Company Directors' Disqualification Act 1986](#).

It is important to note that a company is a separate legal entity, subject to statutory controls. Directors are responsible for ensuring that the company complies with such statutory controls. In particular, it is the responsibility of the directors to ensure that the company maintains full and accurate accounting records. Company accounts should, subject to various exemptions, be filed with the Registrar of Companies at [Companies House](#).

A company is a separate legal entity

²⁴ The Articles of Association sets out the rules for the running of the company's internal affairs. All companies must register Articles with Companies House - it is one of a number of key documents required to incorporate a UK company

²⁵ Companies set up prior to 1 October 2009 listed their objectives in the Memorandum of Association. These are now deemed to be part of the Articles unless a resolution to remove them has been passed

Box 10: The Companies Act 2006

The [Companies Act 2006](#) sets out seven general duties of directors:

- 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.
- To promote the success of the company for the benefit of its members.
- To exercise independent judgement.
- To exercise reasonable care, skill and diligence.
- To avoid conflicts of interest.
- Not to accept benefits from third parties.
- To declare an interest in a proposed transaction or arrangement.

5.2 Directors' liabilities

Legally, there is nothing in law to prevent a director of an insolvent company from starting a new business 'overnight' provided that he has acted 'properly' in managing the first company both before and during its insolvency. However, if the director of an insolvent company has deliberately acted to the detriment of the company's creditors, action may be taken against him under both insolvency and company legislation. Such actions might include accusations of wrongful or fraudulent trading (see **Boxes 11** and **12** below).

Directors may incur personal liability, both civil and criminal, for their acts or omissions in directing the company.

Box 11: Wrongful trading – section 214, IA 1986

There are circumstances in which directors of an insolvent limited liability company can be held personally liable for the company's debts.

Section 214(2)(b) of the IA 1986 outlines the offence of wrongful trading. A director may be liable to contribute personally to the assets of the insolvent company for the benefit of its creditors 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.

In effect, wrongful trading occurs when the director knew or ought to have concluded before the company became insolvent that there was no reasonable prospect of avoiding insolvency, yet continued to trade. Action under this section would be taken by the liquidator in conjunction with specific orders from the court.

This section applies to any person who is or was a director of a company which subsequently goes into insolvent liquidation. However, a director may not be made personally liable in circumstances where he can show that he took every step prior to the liquidation to minimise the potential loss to the company's creditors.

It should be noted that the [Small Business, Enterprise and Employment Act 2015](#) (Section 246ZB) extends the powers to take action against directors for wrongful trading (which previously were only available to a liquidator) to an administrator.

The dilemma facing a director of a company which is at risk of going into insolvent liquidation is whether to carry on trading or put the company into administration or liquidation. The duty imposed is to minimise the loss to creditors, obviously, the steps to be taken will vary from case to case.

Box 12: Fraudulent trading – section 213, IA 1986

Fraudulent trading is where a company carries on a business with the intention of defrauding creditors (or potential creditors) or for any fraudulent purposes. This applies whether the company is trading, has ceased trading or is in the process of being wound up.

Specifically, **section 213** of the IA 1986 states:

- A director of a company who disposes of company assets (including cash) prior to liquidation may, in certain circumstances, be guilty of fraudulent trading under Section 213 of the IA 1986.
- The powers of Section 213 can be invoked even if only one transaction is involved and only one creditor is defrauded.

In effect, the court may require a director to make a personal contribution to the company's assets if, in the course of the winding up of a company, a director was knowingly a party to the carrying on of the company's business with the intent to defraud the creditors. It has been held that an intent to defraud may be inferred if a person obtains credit when he knows that there is no good reason for thinking that funds will be available to pay the debt. However, there must be evidence to justify a finding of actual dishonesty. If this is proved then the director will, in addition to being liable to contribute to the company's assets, be guilty of a criminal offence.

It should be noted that the [Small Business, Enterprise and Employment Act 2015](#) (Section 246ZA) extends the powers to take action against directors for fraudulent trading (which previously were only available to a liquidator) to an administrator:

- If while a company is in administration it appears that 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 following has effect.
- The court, on the application of the administrator, may declare that any persons who were knowingly parties to the carrying on of the business in the manner mentioned in subsection (1) are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

Box 13: Recovery for misfeasance – section 212, IA 1986

The official receiver, a liquidator, a creditor or a shareholder can recover money or damages from officers of the company or those concerned in its management, who have misapplied or retained or become liable or accountable for any money or property of the company, or have been guilty of misfeasance or breach of fiduciary or other duties in relation to the company.

Section 212 will cover, amongst other things, improper payments of dividends, application of monies for an improper or unauthorised purpose, application of monies contrary to the Companies Acts, and unauthorised loans or payments of unauthorised remuneration to its directors.

It is important to note that section 212 applies in addition to the rules relating to common law misfeasance, but provides a speedier remedy than is available under the common law.

Box 14: Transactions at an undervalue or a preference - sections 238 and 239, IA 1986

As already outlined in section 2.3 of this paper (see above), in certain circumstances, a liquidator may be able to begin a recovery action on behalf of the creditors. Specifically, there may be grounds for having disposal of company assets transactions set aside (i.e. cancelled) by the court on the grounds that they are preference transactions or transactions at an undervalue, provided the transactions were entered into **at a time** when the company was unable to pay its debts.

A **transaction at an undervalue (section 238)** occurs when a company disposes of its assets for significantly less than they are worth. A liquidator can apply to have the transaction set aside if it occurred within two years of the company's liquidation.

A **preference (section 239)** is a transaction which has the effect of placing a creditor in a better position if the company goes into liquidation than if the transaction had not occurred.

If the transaction occurs within 6 months before the company's liquidation, the liquidator can apply to have it set aside but he must prove that the directors in entering into the transaction were influenced by a desire to produce the preferential effect.

In the case of a transaction with a creditor who is a 'connected person' (e.g. any of the company's directors or shareholders) the period of 6 months is extended to 2 years and it is also presumed (unless the contrary can be proved) that there was a desire to prefer the creditor.

5.3 Disqualification of an unfit director

Overview

Director disqualification is the process whereby a person is disqualified, for a specified period, from becoming a director of a company, or directly or indirectly being concerned or taking part in the promotion, formation or management of a company without permission from the court. The [Company Directors Disqualification Act 1986](#) (CDDA) applies.

It is important to note that disqualification proceedings are a civil, not criminal, process. Disqualification orders are made by the court and can be between 2 and 15 years (see **Box 15** below). Alternatively, directors may offer to give a disqualification undertaking. An undertaking is the administrative equivalent of a disqualification order and can be entered into, voluntarily, without the need for court proceedings. Once accepted by the Secretary of State it has the same effect as a court order and can only be amended by the court.

In terms of effects, unless he or she has court permission, the person is disqualified by the CDDA for the period stated in the order or undertaking from:

- Acting as a director of a company
- Taking part, directly or indirectly, in the promotion, formation or management of a company or limited liability partnership
- Being a receiver of a company's property
- Acting as an insolvency practitioner

In addition to the above many other restrictions are placed on disqualified people by other legislation and regulations.

The ban on being a director applies to all registered and unregistered companies formed in England, Wales and Scotland. It also applies to foreign companies if the company:

- Is registered in England, Wales and Scotland
- Has sufficient connection to England, Wales or Scotland (for example, if it carries on business or has assets here) even if it is not registered here.

The above restrictions also apply in Northern Ireland.

Anyone contravening a disqualification order or undertaking is committing a criminal offence and can be fined and/or sent to prison for up to 2 years. They could also be disqualified for a further period. When someone contravenes an order or undertaking, they might also become personally liable for any debts of a company that are incurred during that period.

If the disqualified director asks somebody to act on their behalf then that person could also be prosecuted and/or disqualified and become personally liable for the company's debts. If it is a corporate director that is disqualified, then its officers or managers can be punished as if the order or undertaking applied to them personally for any contravention of the order or undertaking by the corporation.

Box 15: Unfit conduct – disqualification of a director

Section 6 of the [Company Directors Disqualification Act 1986](#) (CDDA 1986) [as amended by the *Insolvency Act 2000*] enables the court to make a disqualification order of between 2 and 15 years for unfit conduct as a director. 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 over to the Crown tax or other money due
- failure to co-operate with the Official receiver /insolvency practitioner

As a result of a disqualification order, the person named on the order must not:

- act as a company director;
- be involved with the formation, marketing or running of a new company
- act as a receiver of a company's property

However, a disqualified director may carry on business as a sole trader or partner in an unlimited liability partnership.

Instead of a court order under the CDDA 1986, the Secretary of State may accept an undertaking from an unfit director. Such an undertaking would have the same legal effect as a disqualification order made by a court.

It is a criminal offence to contravene a disqualification order or undertaking.

It is also a criminal offence for another person to assist a disqualified person to act in this way.

Importantly, a person who contravenes the order or undertaking could also become personally liable for any debts of the company which it incurs while the order or undertaking is contravened.

The Small Business, Enterprise and Employment Act

A package of new measures contained in the [Small Business, Enterprise and Employment Act 2015](#) (the 'SBEEA 2015') has strengthened the director disqualification regime.²⁶ These new measures came into force on **1 October 2015**. They implement proposals outlined in the '[Transparency and Trust](#)' consultation that took place in 2013/14.²⁷ They emphasise accountability with provisions that:

- give the Secretary of State and the courts the power to disqualify a person convicted of a company related offence abroad;
- allow for the disqualification of a person who influences or instructs unfit directors;
- set out (and broadens) the matters that the Secretary of State or the court must take into account when considering whether a person should be disqualified (the matters will include breaches of laws or regulations, the loss or harm their conduct has caused and the director's track record in running failed companies);
- extend from 2 years to 3 years the period in which the Secretary of State can apply to court for a disqualification order against the director of an insolvent company;
- remove the restrictions on what material he can rely on when seeking a disqualification in other cases (this will allow the Secretary of State to use information from other regulators in his proceedings);
- create compensation orders and undertakings meaning that a disqualified director can be required to pay the amount of money creditors lost through his misconduct (compensation can be sought for conduct that occurs on or after 1 October 2015).

A new streamlined mechanism for reporting a director's misconduct in insolvent companies is expected to become operational in April 2016, with the first of the new online conduct reports expected to be submitted in June 2016.

Report a disqualified director

Some disqualified directors may deliberately disregard disqualification orders made against them. Anyone who has information about the business conduct of a disqualified director can pass on that information to the Insolvency Service using a [dedicated web site](#).²⁸

Anyone can search the Disqualified Directors Register by visiting [Companies House](#) and going to the 'Find Company Information' page; then clicking on 'Disqualified Directors Search'. This register will also indicate if a disqualified director has obtained permission from the court to act in relation to specified companies.

²⁶ By sections 104-116 of the [Small Business, Enterprise and Employment Act 2015](#)

²⁷ Department for Business Innovation and Skills (BIS), '[Transparency and Trust: Enhancing Transparency of UK Ownership and Increasing Trust in Business – Discussion paper](#)', July 2013, [online] (accessed 4 February 2016)

²⁸ An Enforcement Questionnaire can be obtained from www.insolvency.gov.uk A search can be made of the [disqualified directors register at Companies House](#)

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