

Directors' concerns: Facing insolvency and wrongful trading

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During the lifetime of a company some of the most difficult problems that a director faces are encountered if the company is in financial difficulty: not yet unable to pay its bills and insolvent but with a possibility that it may get to that position. At that stage the decisions made by a director may affect not only the survival and future of the company but also the director's own position.

The range of options for a Jersey company that is in financial difficulty is relatively limited. If a company becomes unable to meet its debts as they fall due, the main options available to it are:

- insolvent winding up (a **Creditors' Winding Up**) under the Companies (Jersey) Law 1991 (the **Companies Law**), a procedure which may be initiated either by the shareholders of the insolvent company or, since March 2022, by a creditor;
- a declaration by the court that the property of the insolvent company is en désastre under the Bankruptcy (Désastre) (Jersey) Law 1990 (the **Désastre Law**), a bankruptcy procedure which may be initiated either by the shareholders of the insolvent company or by a creditor and which is by way of liquidation of the company's assets to meet liabilities and dissolution.

Directors of a company that is in financial difficulty are not obliged to commence either type of proceeding but are under a duty to consider the position of creditors and may become personally liable for the debts of the company in certain circumstances: wrongful trading. Commencing an insolvency proceeding may be the best way of protecting creditors' interests but that would not necessarily be the case if the company had a reasonable prospect of trading through the difficulties with careful management. Directors may also be liable for claims for breach of duty as a director. In addition, the court has power to disqualify people from acting as directors if their actions make them unfit to be concerned with the management of a company.

The duties of a director are usually owed strictly to the company (and to no other person) and are to act with a view to the best interests of the company. Where, however, the company is in financial difficulties, the duty changes and directors must consider matters differently and act with a view to minimising the loss to creditors. It is likely that the Jersey courts, although not bound by the decision, will find the Supreme Court's decision in *BTI 2014 LLC v. Sequana S.A.* [2022] UKSC 25 persuasive in this regard. The court confirmed that where the company is insolvent, or bordering on insolvency, but is not faced with an inevitable insolvent liquidation or administration, the directors should consider the interests of creditors, balancing them against the interests of shareholders where they may conflict. The greater the company's financial difficulties, the more the directors should prioritise the interests of creditors. The interests of creditors are the interests of creditors as a general body. The directors are not required to consider the interests of particular creditors in a special position. All members of the Supreme Court agreed that, where an insolvent liquidation or administration is inevitable, the creditors' interests become paramount as the shareholders cease to retain any valuable interest in the company.

If a director of a company knows that there is no reasonable prospect that the company would avoid a creditors' winding up or the making of a declaration under the *Désastre Law*, in the course of a subsequent winding up or *désastre*, the court may order that the director be personally responsible without limit for any debts of the company incurred after the director became aware that there was no reasonable prospect

of avoiding insolvency. The director may also be liable if the director is, on the facts known to the director, reckless about the prospect of avoiding a winding up or declaration. The court cannot make such an order for the director to be personally liable, however, if it is satisfied that from the time when the director knew that there was no reasonable prospect of avoiding insolvency, the director took reasonable steps with a view to minimizing the potential loss to the creditors of the company.

If a director is concerned about the financial position and prospects of the company, the legal position needs to be considered as carefully as the financial one and the following questions need to be asked:

- what is the test for knowing when a director is at risk of being liable for wrongful trading?
- in circumstances where wrongful trading may be a risk, what should a director do?
- what are the consequences of wrongful trading?

The Companies Law sets the following test for a director being liable for wrongful trading:

'if at a time before the date of commencement of the creditors' winding up of the company that person as a director of the company -

- (a) knew that there was no reasonable prospect that the company would avoid a creditors' winding up or the making of a declaration under the *Désastre* Law; or,
- (b) on the facts known to the director was reckless as to whether the company would avoid such a winding-up or the making of such a declaration.'

Whether or not there is a reasonable prospect of avoiding insolvent winding up is a matter for the knowledge and judgment of the director. Being aware of the financial position of the company and of its ability to meet its liabilities as they fall due is an inherent part of the general duty of a director to act honestly and in good faith in the best interests of the company using the care diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The period when a director must begin considering the risk of the company becoming insolvent may begin before creditors start threatening the company, cheques begin to bounce or overdraft limits are exceeded if, for example, the accounts show that the company is in difficulty and without a change in circumstances, may become insolvent. In one case the court concluded that as soon as the directors knew a creditor had refused further supplies because of lack of payment and that other creditors were pressing, they should have introduced some financial controls which would have shown the inevitability of insolvent liquidation.

In relation to assessing the risks facing the company and its financial position, the directors will need to take into account not only the cash-flow, assets and liabilities of the company but also the general economic environment within which it operates. A company may have investors which it believes are interested in providing additional funds to it but it must assess realistically the prospect that investors may not complete their investment and that the time required for securing an investment may be longer than either party anticipates. Timing is an important factor because the test for insolvency under the *Désastre* Law is cash flow insolvency and cash flow insolvency is relevant also to commencing a creditors' winding up under the Companies Law. Consequently, whilst the company may have valuable assets that would mean that in a winding up ultimately all of its creditors would be fully paid or (with a little more time) may have good prospects of raising additional funds, that would not prevent a *désastre* being declared and wrongful trading becoming a risk if, at any stage, it had cash flow problems and found itself unable to meet its liabilities as they fall due.

Directors need to be considering the issue of wrongful trading effectively from the time that they become aware that the company is in financial difficulty and that there is a foreseeable possibility that it may have to commence an insolvent liquidation, even though there are possible avenues for it to take which would avoid it ending up in an insolvent liquidation.

If a director becomes concerned about the financial position of the company, there are a number of practical steps that he or she can take that will help to demonstrate that he or she has taken reasonable steps with a view to minimising the potential loss to the creditors of the company so that the court will not make an order that the director be liable for wrongful trading. Amongst other matters, each director should:

- keep a close eye on the day-to-day cash flows and liabilities of the company including timetables and financial milestones for raising additional funds;

- ensure that regular board meetings are held to keep the financial position under review and, so far as possible, all directors should be present or ensure that they are kept informed;
- ensure that the minutes are circulated as soon as possible after the meetings as evidence of the actions taken by the directors with a view to minimising potential losses to creditors;
- ensure that the company takes professional advice, for example from lawyers and accountants in respect of solvency issues and how to minimise the effect on creditors;
- ensure that the company reviews and pursues potential sources of capital;
- ensure that the company avoids so far as possible incurring fresh liabilities which it may be unable to meet;
- ensure that the company negotiates with creditors to postpone payments, or negotiates to cap any liabilities or termination claims which may arise if payments cannot be made;
- check the terms of directors and officers insurance; and
- ensure that careful records are kept of all advice that is received and all steps that are taken.

Individual directors should also keep their own records of meetings and ensure that if they are not in agreement with a resolution their dissent is noted. Wrongful trading is assessed by reference to each individual rather than the board collectively. Ultimately a director may need to consider resigning but resignation may not protect a director because each director is required to take reasonable steps to minimise potential loss from the relevant time: simply resigning may not achieve this.

In summary, for as long as its financial position is at risk, the directors of a company should ensure that their decisions represent reasonable steps to minimise potential losses to creditors of the company. Necessarily, the extent and nature of those steps depend upon the exact circumstances in which the company finds itself.

If a director of a company is found to have been responsible for wrongful trading, the court may order that the director is personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company arising after the time at which the director knew that there was no reasonable prospect that the company would avoid a creditors' winding up or the making of a declaration under the *Désastre* Law or, on the facts known to the director, was reckless as to whether the company would avoid such a winding-up or the making of such a declaration.

If it appears to be in the public interest, an application may be made to the court for disqualification of the director so that without leave of the court he or she may not be a director of or in any way, directly or indirectly, concerned with or take part in the management of a company including, from Jersey, in a company incorporated outside Jersey. The court can make such an order where it is satisfied that a director is 'unfit'. In order, to justify a disqualification order, the behaviour must be serious. Ordinary commercial misjudgement is not in itself sufficient to justify disqualification. In particular, continuing to trade and seeking to find additional investment and funds may not justify disqualification if the actions taken offer a reasonable prospect of minimising losses to creditors.

In some circumstances shareholders may have a claim against directors for breach of duty to the company and certain common law claims may be raised by creditors in relation to the management of companies.

The Companies Law also includes penalties for fraudulent trading if it appears that the business of a company has been carried on with an intent to defraud anyone or with any fraudulent purpose. Not carrying on business fraudulently is, however, something that directors must consider at all times and not only when the company is in financial difficulties.

Contacts

A full list of contacts specialising in corporate law can be found [here](#).