Directors' Responsibilities

Don't let the company's financial difficulties become those of the directors!

Companies that are experiencing difficulty often need an independent opinion on the position of the directors.

Common questions include:

- What are my responsibilities?
- What actions should I take?
- Will I be accused of wrongful trading?
- Do I cease trading as soon as I suspect insolvency?
- How do I identify insolvency?

In many cases directors will have given personal guarantees to landlords, banks, factoring firms and lease companies.

They will be anxious to ensure that they minimise the risk to themselves as well as to ensure they meet their obligations to creditors.

Close monitoring of the financial position is critical

Wrongful Trading

This Update focuses on some practical issues surrounding wrongful trading.

The question often arises as to whether the insolvency practitioner acts for the company or for the creditors when advising directors of a company in financial difficulty.

It is commonly accepted that the practitioner provides advice and guidance to the directors and the company as to how they should act in the best interests of the creditors.

Having started by acting for the company, if it were to subsequently enter into a formal insolvency procedure (administration, liquidation etc) then the primary duty would shift to the creditors.

Case Study: Packer*

Packer was a venture firm backed supplier of packaging materials to high tech industries.

The directors had run out of venture backing and were looking to raise bank finance. They were concerned about their personal positions whilst a funding line was being secured.

The first question the directors needed to answer was "*is Packer insolvent*?"

A company is insolvent either if it cannot pay its creditors as and when they fall due (the cash flow test) and/or the liabilities exceed the assets (the balance sheet test).

Packer did not appear to be insolvent although the company appeared to be heading towards balance sheet insolvency since its net assets of £250,000 were forecast to turn into net liabilities of some £140,000 by the end of month 3.

* Company name changed for anonymity

Continued:

Packer had cash assets of some £293,000 (cash and debtors) and liabilities of £134,000 but this was on the basis that all liabilities had been factored into the month 1 balance sheet and that the debtors were good - i.e. collectable. The failure of one or two large customers to pay their debts or delayed payment would have caused a cash flow crisis since Packer was right up against its £200,000 overdraft limit without the ability to raise fresh short term funds.

The forecasts clearly showed that Packer was probably heading towards insolvency on a cash flow basis unless new cash was introduced or significant cost savings made.

This was because the cash flow projections showed that Packer continued to absorb cash into Month 5 making the cash position worsen further.

Impact of Actions

The CEO believed that he could reduce staff numbers and generate the cash needed to permit the company to continue to trade, pay old creditors and new creditors that arose in the course of trading.

The CEO was advised to demonstrate this in the cash flow and trading projections taking account of redundancy costs.

The Board was advised to challenge the assumptions behind the forecast and satisfy itself that it was well founded, based on sound assumptions and that there was a reasonable prospect that all debts would be paid as and when they fell due.

In determining whether wrongful trading has taken place the court will apply an objective test - based on what the directors ought to have known.

Directors' access to financial information will be important to establish if the company can trade out of it's financial difficulty.

There is also a subjective test based on directors' personal expertise and qualifications. A finance director might have a higher duty of care than a marketing director.

The directors must continue to monitor the company's financial position very closely for any change. Regular board meetings should be held and minuted.

The company should not, without advice, enter into any contract with a connected person

Preemptive Actions

Wrongful trading might occur if the directors knew or ought to have concluded that there was no reasonable prospect that the company would have avoided going into insolvent liquidation and should have ceased to trade. A director who resigns now might be accused of not taking every step to minimise the loss to creditors.

Packer closely monitored its financial position:

- It monitored its debtors to ensure compliance with bank lending covenants
- It forecast cash flow on a weekly basis and used this as a plan for debtor collections and creditor payments
- It reviewed trading forecasts each month to ensure the company remained cash positive
- It cut costs and maintained a tight control over expenditure

Gore and Company provided a monthly report to the Board to give them assurances that the company was trading well within its financial resources until new lending was obtained.

This report could have been cited by the directors in their defence in the event of a challenge from creditors or from a liquidator.

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