



U.K. and U.S. Private Companies

Fiduciary Duties of Directors of Financially Troubled Corporations

DECEMBER 1, 2021

Imran Aslam
John Willard

Always exceed expectations through teamwork and excellent client service.

Introduction

- Discussions around directors' duties is currently very topical.
- For the last 18-24 months, following the pandemic, directors have had the benefit of a number of government initiatives, including moratoriums of action against directors, (e.g. in the U.K. temporary amendment / suspension to the wrongful trading rules) and the provision of cash.
- However, such measures have come to an end, and therefore directors conduct have come into a sharp focus, as well as how those directors behaved during the pandemic, especially in a distressed context.

U.S. Perspectives – Overview

- **Directors' Primary Fiduciary Duties**
- **Fiduciary Duties:**
 - Solvency and Zone of Insolvency
 - Insolvency
 - Bankruptcy
 - Post-Bankruptcy
- **Directors' Exposure**

U.K. Presentation Overview

- Preliminary Points
- Directors' Duties in an Insolvency Context/When a Company is Facing Financial Difficulties
- Liabilities of Breach of Directors' Duties
- Practical Steps for Directors of a Company Facing Financial Difficulties/Mitigating Directors' Exposure

U.S. Perspective

Directors' Two Primary Fiduciary Duties

1. Duty of Care; and

2. Duty of Loyalty

- Other duties, like the duty of good faith, duty of oversight, and duty of disclosure stem from these primary duties.
- Additional duties may stem from corporation's organizational documents, or the SEC and stock exchange (for publicly traded corporations).
- Statutory and common law.

Duty of Care

- **Focus is on decision-making *process* (rather than outcomes).**
 - Act with care that a person in a like position would reasonably believe appropriate under similar circumstances.
 - Evaluation of key information points.
 - Directors can (and should) rely on experts' reports.
 - Minute-taking.
 - Inaction can trigger liability.

Duty of Loyalty

- **Must act in good faith for the benefit of the corporation and its shareholders, not for directors' personal interests.**
 - **Disinterestedness**
 - Avoid self-dealing.
 - Avoid diversion of corporate opportunities for personal gain.
 - Avoid deliberations which may affect personal liability (e.g., personal guaranty of corporate debt).
 - Disclose conflicts.
 - **Independence**
 - Recusal appropriate if “dominated” or “controlled” by an interested party.

To Whom Are Fiduciary Duties Owed?

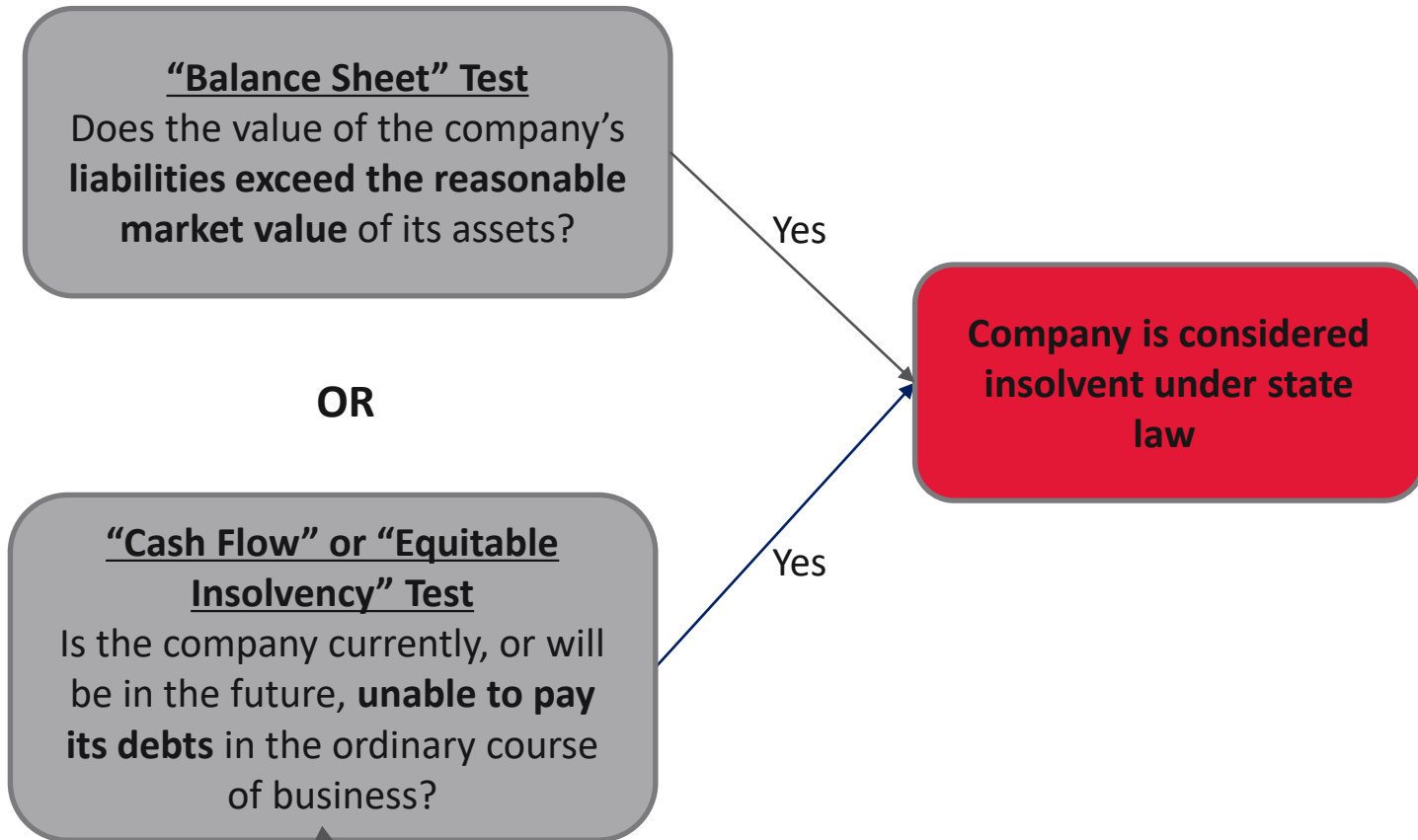
- ***When a corporation is solvent, directors owe their fiduciary duties to the corporation and its shareholders. That remains true when the corporation is in the “zone of insolvency.”***
 - The corporation itself has standing to bring direct actions against the directors.
 - Shareholders have derivative standing to bring claims against the directors on the corporation’s behalf.
 - Zone of insolvency often encourages risky, preferential and even fraudulent transactions.
 - Exposes board to liability;
 - Transactions can be unwound if properly challenged.

To Whom Are Fiduciary Duties Owed? (cont'd)

- *If the corporation becomes insolvent, directors owe their fiduciary duties to the corporation and all of its constituencies, including its creditors.*
 - Once insolvent, a corporation's directors' fiduciary duties expand to include creditors because the interest of stockholders are subordinate to those of creditors.
 - Once insolvent, a corporation's creditors have standing to bring derivative – not direct – actions on behalf of the corporation against the board.
 - Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

The Test for Insolvency

- There are two traditional U.S. state law tests for determining insolvency:



To Whom Are Fiduciary Duties Owed? (cont'd)

- ***When a corporation files for bankruptcy, fiduciary duty claims are governed by state corporate law (i.e., duty of care and loyalty) and federal bankruptcy law.***
 - Duty to maximize value of the bankruptcy estate, refrain from self-dealing, and treat all parties-in-interest fairly.
 - Bankruptcy court must approve non-ordinary course transactions (e.g., 363 sales, bidding procedures, appointment of plan sponsor, etc.).
 - Causes of action against directors for breaches of fiduciary duties become property of the estate which the debtor-in-possession (or trustee, if one is appointed) has the near-exclusive right to pursue.
 - Standing: DIP vs. UCC (derivative).
 - Tension: appointment of “independent” directors vs. examiner or special trustee vs. Committee as to who will investigate potential fiduciary duty claims.

To Whom Are Fiduciary Duties Owed? (cont'd)

- **Post-emergence from bankruptcy, pre-petition fiduciary duty claims are governed by the confirmed plan of reorganization.**
 - Section 1123(b)(3) of the Bankruptcy Code permits retained causes of action to vest in the reorganized debtor or liquidating trustee.
 - Typically, the plan of reorganization provides that the vesting of fiduciary duty claims in the reorganized debtor or liquidating trustee precludes creditors from pursuing such claims.
 - As part of the global settlements embodied in plans of reorganization, typically the DIP grants broad releases of its claims against officers and directors.

DIRECTORS' EXPOSURE –

(I) Breach of *Duty of Care*: Failure of Oversight

- **Oversight is a component of the duty of care.** The board must implement an adequate system for reporting issues to the board.
- "**Caremark**" claim: the plaintiff alleges the board failed to oversee the company to a degree tantamount to **bad faith**.
 - The directors **failed to implement** any reporting processes, or information system or control; or
 - Having implemented a system or controls, the directors **consciously failed to monitor** or oversee its operations.

DIRECTORS' EXPOSURE –

(II) Breach of *Duty of Loyalty*: Bad Faith

- To act in good faith, a director must act with honesty of purpose and in the best interest of the corporation.
- Situations that usually involve bad faith include:
 - An **intentional failure to act** in the face of a known duty to act, demonstrating a **conscious disregard** for one's duties.
 - A **knowing violation** of the law.
 - Acting **for any purpose other than advancing the best interests of the corporation** or its shareholders.
 - Beyond gross negligence.

DIRECTORS' EXPOSURE –

(III) Breach of *Duty of Loyalty*: Conflicts

Disinterestedness and independence are determined on a director-by-director basis.

- If a majority of the directors are disinterested and independent, the decision is not considered conflicted and all directors are entitled to the presumption that they acted in the corporation's best interest (business judgment rule).
- If half or more of the directors are not disinterested and independent, the decision is considered conflicted and the presumption of acting in the corporation's best interest is lost.
- The presumption can be restored by convening a **special committee of independent and disinterested directors**.

DIRECTORS' EXPOSURE –

(III) Breach of *Duty of Loyalty*: Conflicts (*cont'd*)

- Directors are not automatically liable in conflict transactions, even if the transaction is ruled unfair to the shareholders.
- If the charter contains an exculpatory provision for breaches of the duty of care:
 - Any directors *who themselves are disinterested and independent* are only liable if they approved the transaction in subjective bad faith.
 - Any director lacking in disinterest or independence is subject to damages *regardless of subjective intent*.

U.K. Perspective

Preliminary Points

Who are the duties owed by?

- The term “**director**” has an extended meaning. It includes not just directors properly so called, but also those who “*pull the strings*” of a company although they may not formally be on the board, e.g., “*shadow directors*.”
 - “**Shadow director**”, in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity).”
- It may also **cover parent companies** (that is, a parent company may be the shadow director of a subsidiary) where the parent or the directors operate with an extensive 'hands-on' approach to running the company and interfere consistently in its management.

Duties owed to whom?

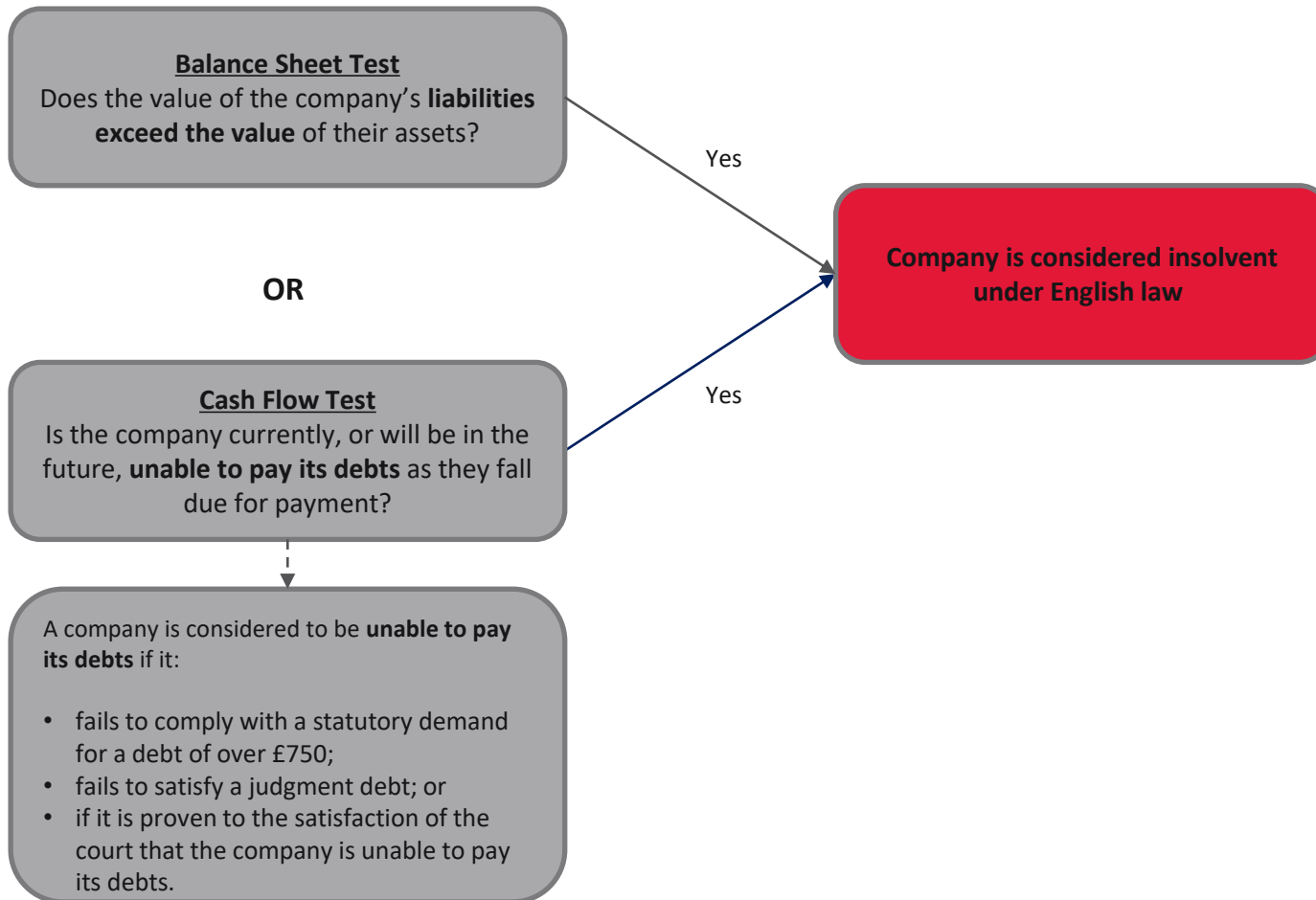
- **Group of Companies**
 - The issues of one company must be considered on a standalone basis and independently from the issues concerning other entities in the same group and the interests of shareholders.
 - It therefore must be remembered that each company is distinct. However artificial it may seem, a director of a number of companies in a group must wear his or her hat as director of each company in turn, individually, and consider the position of that company alone.
- Although the duties are owed to the company, and only the company will be able to enforce them generally, in certain circumstances shareholders may be able to bring derivative actions on the company's behalf in the event of a breach.

Directors' Duties in an Insolvency Context/When a Company is Facing Financial Difficulties

- Under normal circumstances, under the Companies Act 2006 (**CA Act 2006**), directors have a duty to **promote the success of the company**, which involves promoting the success of the company **for the benefit of its members as a whole**.
- However, during the “**twilight period**” of a company, directors must also **have proper regard for the interests of creditors**.
- “**Twilight period**” – exact starting point is ambiguous, but widely held to be during a **period of financial distress** and before the start of a formal insolvency process.
- In addition, during such period, directors still need to bear in mind that their **other general duties under the CA 2006 survive the commencement of an insolvency**, including the duty to:
 - exercise independent judgement;
 - exercise reasonable care, skill and diligence;
 - avoid conflicts of interest; and
 - declare their interest in a proposed transaction or arrangement with the company.

The Test for Insolvency

▪ S.123 Insolvency Act 1986 (IA 1986)



Wrongful Trading (s. 214 IA 1986)

- Actions taken by a director that **ultimately fail to minimise creditor losses**.
- This section applies if:
 - the company has gone into **insolvent liquidation or insolvent administration**;
 - the director in question **knew or ought to have known** that there was **no reasonable prospect** of avoiding insolvent liquidation or insolvent administration; and
 - the director failed to take **every step** with a view of minimising potential further losses to creditors.
- The language of s.214 is drafted widely to capture a wide variety of acts and omissions, not just trading activities.
- “Insolvent” for the purposes of wrongful trading means a company’s assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up of the company (i.e. **the balance sheet test**).
- The director in question is held to an **objective and subjective standard**:
 - The **general knowledge, skill and experience** that may be reasonably expected of a person carrying out the same functions (the objective test).
 - The director’s **actual knowledge**, particular skills and experience (the subjective test).

Wrongful Trading (s. 214 IA 1986)

- Defence:
 - Directors might be able to escape liability if they took **every step** expected of a **reasonably diligent director**, with a view of minimising the potential losses to creditors (the “**every step defence**”).
 - A director may also seek to invoke **s.1157 CA 2006**. This statutory defence is routinely pleaded as a last line of defence and provides the court with the discretion to grant such defence where it is satisfied that the director “**acted honestly and reasonably, and having regard to all the circumstances of the case, he ought fairly to be excused.**” This is in relation to cases involving “negligence, default, breach of duty or breach of trust.”
- Liability/sanction:
 - Contribution order against directors based on the additional depletion of a company’s assets caused by the director’s conduct.
- **Wrongful Trading v. Trading Whilst Insolvent:**
 - Directors that allow the company to trade whilst insolvent **will not be guilty of wrongful trading**; the offence occurs when they allow trading when they knew or ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation/administration.
 - Trading during **short-term cash flow issues** in anticipation of future profit = **trading whilst insolvent**.
 - Incurring additional debt/further expenses knowing fully there is **no hope or little hope of recovery** for the company’s creditors = **wrongful trading**.

Fraudulent Trading (s.213 IA 1986) / Fraud

- If in the course of a liquidation or administration of a company, 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.
- For example, if a director incurs further debt on behalf of a company despite repayment of such debt being unlikely.
- Liability/sanction:
 - The court, on application of the liquidator/administrator, **may declare that any persons who were knowingly parties to the carrying on of the business in such a manner are liable to make such contributions** to the company's assets as the court thinks just; and/or
 - **Imprisonment of up to 10 years on indictment or a fine**, or both under s.993 CA 2006.
- In relation to fraud generally, there have been an increase in cases of actions against directors resulting from their behaviour during the pandemic, e.g. taking government monies (bounce back loans/furlough schemes) and using for improper purposes.

Misfeasance

- If **in the course of a liquidation or an administration of a company**, a director has **misapplied, retained or become accountable** for any money or other property of the company, or has been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.
- Alternatively, the director's misfeasance or breach of duty has **resulted in misapplication or loss of assets**.
- Actions can be brought by liquidators/administrators **and** creditors (including HMRC) (although normally a creditor wishing to make an application would notify the liquidator who would consider bringing an application and thereby avoiding concurrent proceedings).
- Misfeasance **covers the whole spectrum of directors' duties** and therefore includes:
 - **Misapplication of any money or assets** of the company.
 - **Breach of statutory duty**, such as:
 - unlawful loans to a director;
 - a director entering into a contract with his own company and failing to notify the board; and
 - a director failing to act within his powers.
 - **Breach of the duty of care, skill and diligence**.
- Liability/sanction:
 - Repay, restore or account **for the money or property or part of it, with interest** as the court thinks just; or
 - **Contribute such sum** to the company's assets by way of compensation as the court thinks just.

(s.212 and sch.1, para.75 IA 1986)

Reviewable Transactions

- Certain transactions (“**reviewable transactions**”) entered into before the commencement of a formal insolvency procedure (onset of insolvency) and within the respective “relevant time” (i.e. the period of time prior to the onset of insolvency where a challenge can be brought) may be challenged in court by an office holder and **ultimately set aside under the IA 1986**. These powers ensure an office holder achieves the best outcome for the debtor company’s creditors.
- Such reviewable transactions include (but not limited to):
 - a transaction at an undervalue;
 - a preference;
 - an avoidance of a floating charge; and/or
 - a transaction defrauding creditors.
- Although, consequences are severe, for reviewable transactions, i.e. undoing of a particular transaction, usually the time consequences do not apply to the directors personally unless any of the issues noted in the previous slides apply.

Consequences: Disqualification of Directors

- The court will make a disqualification order under s.6 Company Director Disqualification Act 1986 of between **2 to 15 years** if it is satisfied that:
 - the person is or was a director or shadow director of the company which has become insolvent during or after the time the person was a director (or shadow director); and
 - it is **satisfied that the person's conduct as a director is such that the person is unfit** to be concerned in the management of a company.
- An insolvency practitioner has a duty to report a director's conduct to the Secretary of State for the last 3 years of a company's trading. The Secretary of State decides whether to seek a disqualification order.
- Factors taken into consideration include:
 - the extent to which the person was responsible for the causes of any **material contravention** by a company **of any applicable legislative or other requirement**;
 - the extent to which the person was **responsible for the causes of a company becoming insolvent**;
 - the **frequency of misconduct** of the person;
 - **the nature and extent of any loss or harm caused, or any potential loss or harm which could have been caused**, by the person's conduct in relation to a company; and
 - any **misfeasance or breach of any fiduciary duty** by the director in relation to a company.

Consequences: Miscellaneous

DERIVATIVE ACTIONS

- In certain cases involving **breach of duty and/or breach of trust by a director**, a shareholder can bring an action in their own name on behalf of the company to right the wrong done to the company.
 - For example, a shareholder could seek to bring a derivative action where company funds have been directed to a director's personal account in breach of his duties as a director.
- Derivative claims cannot be brought if the matter is capable of and has been correctly approved by the company.
- Derivative action must be in the best interests of the company; personal vendettas will generally lead to the court refusing to proceed with the claim.

HMRC ACTION / CRIMINAL PROSECUTIONS

- HMRC can take action, and criminal prosecutions can be taken, against directors that (a) acted fraudulently, and (b) took government money and used it for improper purposes.

Practical Steps for Directors of a Company Facing Financial Difficulties/Mitigating Directors Exposure

- Much will depend on the precise circumstances and facts of a particular case, but generally the directors should:
 - ensure that they **have adequate up-to-date financial information** on the company and **ensure this information is regularly considered and analysed**;
 - seek **independent professional financial and legal advice** if they have material doubts about the financial viability of a company, and on their conduct;
 - **conduct regular and carefully minuted board meetings** to consider a company's position on a standalone basis;
 - ensure that their decisions are predicated upon **proper commercial considerations** and are taken on a case by case basis, independent advice should be obtained in the case of uncertainty; and therefore ensure **“business critical” payments can be met**, being: (i) payments that relate to the supply of goods or services that are essential for the ongoing trading of the business; and/or (ii) any debts where there is a real threat of a winding up petition being presented if they are not paid or there is a real threat to the business from creditor action;
 - **review material contracts and finance documents** for any material adverse change and/or force majeure clauses which may trigger a suspension/termination of the company's obligations;
 - **engage with lenders** to reschedule any debts that may become difficult to pay due to restricted cash flow;

Practical Steps for Directors of a Company Facing Financial Difficulties/Mitigating Directors Exposure (cont'd)

- **Prepare contingency plans** and consider whether any of the UK Government initiatives are still available to the company which would help alleviate regular outgoings while cash flow is restricted; and
- Ensure that they are **acting in concert wherever possible**, as the advocacy of, for example, the cessation of trade by one director would place a correspondingly greater burden on the remaining directors should they need to justify a decision to carry on.
- Have in place adequate **D&O insurance coverage and an indemnification agreement in place.**
- Seek to maximise **corporate value** for the benefit of all constituents and do not provide **preferential treatment** to shareholders over creditors.
- Avoid conflicts of interest and avoid engaging in any self dealing; **appoint independent directors and restructuring officers if appropriate.**
- Be aware of preference liability in the event of a bankruptcy.

Practical Steps for Directors of a Company Facing Financial Difficulties/Mitigating Directors Exposure (cont'd)

- Abstain from voting, or recuse themselves from deliberations, about matters that may give rise to a conflict of interest.
- Disclose relationships to parties that transact business with the corporation.
- Appoint an independent committee of directors with its own legal counsel and financial advisors to consider and approve conflict transactions.
- Ensure that any insider transactions are entirely fair to the company or approved by a majority (or special committee) of disinterested directors or by shareholders.
- Do not give preferential treatment to insiders or accept personal benefits in exchange for supporting or opposing a particular transaction.

Practical Steps for Directors of a Company Facing Financial Difficulties/Mitigating Directors Exposure (cont'd)

U.S.-Specific: Business Judgment Rule

In making business decisions, directors generally protected by the business judgment rule if they comply with the fiduciary duties of care and loyalty.

- The rule presumes that *disinterested and independent directors* acted:
 - On an informed basis,
 - In good faith, and
 - In the honest belief that the action was taken in the best interest of the corporation.
- The standard for a finding of breach is gross negligence.

Questions?



John G. Willard

jwillard@atllp.com

314.259.4743

John Willard is a banking and restructuring partner in the firm's U.S. Financial and Real Estate Services practice group. He has extensive experience advising a wide range of clients in complex financial transactions and corporate restructurings.



Imran Aslam

iaslam@atllp.co.uk

+44 (0)207 539 7251

Imran Aslam is a partner and head of the firm's Insolvency and Restructuring practice in the U.K. Imran has experience working on a wide range of cross-border and domestic corporate restructuring and insolvency matters.