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Directors' Obligations & Responsibilities in Insolvency Situations

Introduction

The issue of insolvency is one faced by directors of Irish companies with increased regularity in the current economic climate. It is an area fraught with difficulty and pitfalls for anyone inexperienced in these matters. A first step for any prudent board is to seek professional advice in relation to their situation.

Flynn O'Driscoll has over 20 years experience in advising companies and their directors on their obligations and responsibilities in insolvency situations.

This article aims to set out the key issues for company officers which might arise as a result of any potential insolvency proceedings. We have set out herein a general summary covering the meaning of insolvency, outlining the various insolvency proceedings, the potential liabilities of directors and some broad advice regarding courses of action that may be considered by the directors in an insolvency situation. It is worth noting that this article is specifically relating to the law as stated in the Republic of Ireland.

Definition of Insolvency

There are two primary tests of inability to pay debts or insolvency:

- the cash flow test; and
- the balance sheet test.

Applying the cash flow test, a company is insolvent when it is unable to pay its debts as they fall due. The fact that a company's assets exceed its liabilities is irrelevant for the purposes of this test.

Section 214(a), Companies Acts 1963 provides that a company shall be deemed unable to pay its debts in circumstance where a creditor is owed in excess of €1,270, that debt is undisputed, the creditor has served a written demand on the company requesting payment within three weeks and the sum has not been paid within that timeframe. This deemed insolvency can form the basis of a petition to wind up the company.

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The balance sheet test involves an analysis of the balance sheet of the company to determine whether the company's assets are insufficient to discharge its liabilities.



Types of Corporate Insolvency Procedures

There are a number of formal insolvency and winding up procedures applicable to companies as follows:

1. Voluntary Liquidation - Members

This is a form of winding up whereby the members decide for commercial reasons to wind up the company. In order to avail of this process the company is required to be solvent. Under this process all creditor debts must be paid in full.

2. Voluntary Liquidation - Creditors

A voluntary creditor's liquidation occurs whereby the board of directors recommend to the shareholders that the company be placed in liquidation due to their belief that the company is insolvent. An initial step in this procedure is the calling of a shareholders meeting to place the company in liquidation and issuing 10 days notice of a creditors meeting where a liquidator is appointed. A liquidator is tasked with realising the assets for the benefit of the creditors and also investigating the circumstances that led to the winding up and taking appropriate actions.

3. Compulsory Liquidations

A compulsory liquidation involves the appointment of a liquidator by the courts upon petition from a creditor, the company (authorised by special resolution) or a member.

4. Receivership

In practice a receivership will generally only ever arise in an insolvency situation, however, legally it is merely an enforcement of a security. A receiver is appointed by a debt holder with a debenture or charge over assets of the company in circumstances where the debenture or charge gives the power to do so, usually in the case of an event of default.

5. Examinership

An examiner is appointed by the court upon application by the company, its directors, creditors or the shareholders. Examinership facilitates the rescue of insolvent or near insolvent companies and gives them a period of 70-100 days protection of the courts. The examiner who is appointed by the courts is tasked with drawing up a survival proposal which may include a compromise or scheme of arrangement to be agreed by the creditors.

DIRECTORS LIABILITIES

Section 297 of the 1963 Companies Act states that -

If in the course of the winding up 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, the court on the application of the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in



manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

Fraudulent trading

Fraudulent trading is a criminal offence under section 297, Companies Acts 1963 and is based on two basic proofs which are the “intent to defraud” and “knowledge of such intent”.

Essentially, if the directors of a company continue to carry on business or to incur debts at a time when they know that there is no prospect of the creditors ever receiving payment or indeed incur credit on behalf of the company knowing that there is no good reason to think that the funds will be available to pay the debt when it becomes due or shortly thereafter, such conduct on their part constitutes fraudulent trading.

Fraudulent trading will almost always amount to reckless trading. It is also worth noting that the liability for fraudulent trading is not confined to the officers of companies and could be perpetrated by parties who have in some way participated in the fraudulent acts.

Reckless trading

Section 297A of the 1963 Act as inserted by Section 138, Companies Act 1990 defines reckless trading as follows:

An officer of a company shall be deemed to have been knowingly a party to the carrying on of any business of the company in a reckless manner if he was a party to the carrying on of such business and, having regard to the general knowledge, skill and experience that may reasonably be expected of a person in his position, he ought to have known that his actions or those of the company would cause loss to the creditors of the company, or any of them, or he was a party to the contracting of a debt by the company and did not honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts (taking into account the contingent and prospective liabilities).

It should be noted that the section goes on to give relief to any party for personal liability where that person is adjudged by the courts to have acted honestly and responsibly in his conduct of the affairs of the company.

Fraudulent Preference

A fraudulent preference is a payment or disposal of the property of a company, which at the time is unable to pay its debts as they fall due, in favour of any creditor, during or within six months of the commencement of a winding up, with a view to giving the creditor preference over the other creditors. Such a payment is invalid and is recoverable by the liquidator. Where the payment is to a connected party the period of six months is extended to two years.

There are number conditions which must be satisfied before a payment or disposal can be invalidated as a fraudulent preference and crucially one of those is that there must have been a dominant intention to prefer the creditor in question. In many cases a successful defence has been where a claim of oppressive behaviour of the creditor was proved by the defendant.



RECOMMENDED ADVICE

Trading while insolvent is fraught with difficulty. The safest course of action for directors when a company has become insolvent is to take steps to put the company into creditors' voluntary liquidation or petition to the High Court for the appointment of an examiner. The reckless trading provisions do not apply during a period when a company is under the protection of the court.

If for whatever reason the directors do not want to put the company into either liquidation or examinership, or want time to consider the matter, the only absolute safe course of conduct to adopt is to neither take further credit nor reduce the assets of the company.

If the directors decide to continue to trade while insolvent, there is a serious risk of personal liability if the company goes into liquidation. There are a number of steps that they can take to improve their chances of being able to rely on the "*honest and responsible*" defence, including:

- 1) Convening and recording the minutes of frequent board meetings;
- 2) Convening of an extraordinary general meeting of the shareholders under Section 40 of the 1983 act as appropriate;
- 3) Obtaining legal and financial advice from suitably qualified practitioners;
- 4) Preparing detailed budgets/ business plan with a view to trading out of difficulties;
- 5) Keeping creditors informed of the financial state of affairs in relation to the company at all times;
- 6) Ensuring that there can be no suspicion of fraudulent preference, fraudulent or reckless trading through thoroughly documenting all actions/decisions taken in relation to payment of creditors;
- 7) Ensuring all legal, financial, tax and regulatory returns are filed up to date.

Conclusion

In summary, as soon as a director is aware that there is no reasonable prospect of avoiding insolvent liquidation, or fears that is the case, he must convene and meeting of the board and raise the problem with the rest of the board with a view to taking professional advice. Further credit should almost certainly not be incurred pending such advice and the directors must take every step to minimise the potential loss to creditors.

If you have any queries or you require any advice in relation to any subject discussed in this article please contact James Duggan or any member of the firm.

Further legal advice should be sought before taking any further action with regard to this article.