
| RESEARCH ARTICLE

A Shift in the Duties of Directors when the Company is on the Verge of Bankruptcy

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| ABSTRACT

The topic of this study is the change of directors' duties with the change of corporate operation status. The main research jurisdiction is the UK, and the main research node is after the company is on the verge of bankruptcy and enters bankruptcy proceedings. The UK law stipulates the general duties of directors in the Companies Act 2006. In the normal operation of the company, promoting the success of the company and protecting the interests of shareholders is almost an accepted fact in corporate law circles. But when a company faces bankruptcy, the duties of directors often change. The UK bankruptcy law stipulates Wrongful trading and fraudulent trading liability to urge directors to consider protecting the interests of creditors when the company is on the verge of bankruptcy. Directors may be legally liable for damage to the interests of creditors due to some improper behaviours. Therefore, in order to avoid being charged, directors will increase the priority of protecting the interests of creditors when the company is near bankruptcy. This study will rely on the relevant provisions of the Company Law 2006 and the enterprise bankruptcy law to analyse the change of directors' duties.

| KEYWORDS

Bankruptcy, Director, Shareholder, Creditor

| ARTICLE INFORMATION

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1. Introduction

1.1 Background and Core Questions

When people hear company directors, they often conjure images of elite individuals at the forefront of the business world. As the most powerful managers in a company, they are indeed when the company is running smoothly, but everything seems to change when the company is on the verge of bankruptcy. While the company has a bright future, the directors help expand the shareholders' interests and promote the company's success. The creditors behind the shareholders are also happy to receive the benefits of their capital contribution. However, when the company faces a crisis, the creditors often just want their money back. On the other hand, shareholders are often bold enough to continue to keep the company running under the protection of limited liability. As a result, directors' duties often face a significant impact when a company is heading towards insolvency. This essay will analyse directors' duties at different company operations stages. Respectively, after the company is operating normally, facing bankruptcy and formally entering bankruptcy proceedings. The critical point is the reason for the impact on the transformation of directors' duties by analysing the relevant legislation governing directors' duties and examining the case law in which directors were involved during the insolvency.

2. General Duties of Directors

Following the core requirements of the UK Corporate Governance Code, the board of directors is responsible for protecting the shareholders' interests and promoting the company's long-term success. UK company law provides that a company is regarded as an individual with a separate legal personality. Therefore, if the company is a separate person, the directors are the officers who give orders to it. It follows that directors have enormous powers and significant duties in a company. The agency theory underpins

the relationship between shareholders, companies and directors. Directors act as agents entrusted by shareholders to manage the company's operations. It is their primary fiduciary responsibility as agents to meet the duties entrusted to them. Concerning the duties of directors, the general duties are owed by a director to the company. 'The primary legislation is the CA 2006 Pt.10 Ch.2, which set out a statutory statement of directors' general duties for the first time.'¹ The general duties of directors are discussed in the following section through an article-by-article analysis of the Act.

[T]he duties of directors are set out in the Companies Act as follows: Directors have the duty to promote the company's success;² Directors have the duty to exercise independent judgment;³ Directors have the duty to exercise reasonable skill, care and diligence.⁴

From the above legislative provisions, directors, as agents entrusted by the shareholders to govern the company, protecting the shareholders' interests and promoting the company's success is the basis of all their duties. To deal with the complexities of running a company, directors need to exercise their decision-making powers carefully, as this affects the company's direction and the value of the company's shares, which are directly linked to the interests of shareholders.

[C]ompanies Act 2006 also regulates that directors have the duty to avoid conflicts of interest;⁵ directors have the duty not to accept benefits from third parties;⁶ directors have the duty to declare interests in proposed transactions or arrangements with the company.⁷

These legislations address issues with agency problems that arise between the principal and the agent according to the principle of agency. 'The issue with this corporate ownership structure is that the agents do not always act in the principal's best interests.'⁸ Directors, acting as agents, and shareholders, acting as principals, have distinct goals and, consequently, varying levels of risk aversion.

[A]s Magdalena Jerzemowska describes this conflict of interest: the company's objective is to maximise the market value. It often does not align with the interests of the managers. The managers prefer to maximise their interests, if possible, even at the expense of the owners' interests.⁹

A company's success should be sustainable in the long term, which is to some extent in line with what shareholders seek because shareholders tend to seek long-term gains and share price increases. The focus of some directors on maximising short-term profits may place the company in a high-risk market. To avoid this conflict of interest, directors need to ensure that they put the interests of the company and its shareholders before their own. Maintaining transparency in the information they receive about their interests when conducting business can be beneficial in regulating possible behaviour by directors that could be detrimental to the company's success.

3. Directors' Duties in Insolvency Proceedings

When a company is in insolvency proceedings, the directors' primary duty is to protect the interests of creditors. Previously discussed were the duties of directors when the company is operating normally. However, this changes dramatically when the company is facing insolvency. When a company suffers difficulties that make it impossible to continue operating, there are several different options for the company to make a choice. The most common forms are administration proceedings, liquidation proceedings and forced insolvency. 'Under the Enterprise Act 2002, an administrator is appointed to take over the company in administration proceedings once an administration is initiated.'¹⁰ Therefore, the duties and powers of the directors in administrative proceedings are not obvious. 'Liquidation proceedings are a direct settlement of interests between the company and its creditors.'¹¹ Focusing on liquidation proceedings provides a more visual representation of the centrality of directors' accountability to creditors in insolvency proceedings. The first option is the member's voluntary liquidation. This usually occurs when a company is still solvent but does not wish to continue in business.

[A]ccording to the insolvency rules 1986, after reviewing the company's accounts, the directors are required to call upon a general meeting and to issue the solvency statement in the name of the company to ensure that the company can pay its

¹ Robert Goddard, 'Directors' Duties' (2008) 12 *Edinburgh L Rev* 468, 468

² Companies Act 2006, s 172

³ Companies Act 2006, s 173

⁴ Companies Act 2006, s 174

⁵ Companies Act 2006, s 175

⁶ Companies Act 2006, s 176

⁷ Companies Act 2006, s 177

⁸ Jill Solomon and Aris Solomon, *Corporate Governance and Accountability* (John Wiley & Sons 2004) 17

⁹ Magdalena Jerzemowska, 'The Main Agency Problems and Their Consequences' (2006) 14 *AOP* 9, 11

¹⁰ Enterprise Act 2002, s 248

¹¹ Janet Dine and Marios Koutsias, *Company Law* (8th edn, Palgrave Macmillan 2014) 455

debts within the next twelve months. It is a criminal offence for directors to make a false declaration.¹²

Through the analysis of the above procedures, the directors' primary duty is to properly assess the company's asset affairs, which can be seen as part of the protection of the interests of creditors. When a company is facing operating difficulties, the percentage of financial loss is often raised rapidly. Suppose the directors cannot assess the company's solvency correctly, which delays the company's entry into insolvency proceedings. In that case, the interests of creditors will continue to be prejudiced. When a solvency statement has been issued, the directors are responsible for calling a general meeting to appoint a liquidator to control the company. The second option is the creditor's voluntary liquidation.

[F]rom the section 90 of Insolvency Act 1986, the principal difference between a creditors' voluntary liquidation and a members' voluntary liquidation is that, in a members' voluntary liquidation, the directors make a declaration that the company will be able to pay its debts in full within a maximum of twelve months. If not, the liquidation would become the creditor's voluntary liquidation automatically.¹³

Directors are required to call a general meeting of shareholders to decide to wind up the company during the creditors' voluntary liquidation. The meeting participant will then name the liquidator and suggest the liquidation committee. A meeting of creditors will be called following the general meeting, and directors must ask creditors to attend. Directors would provide a thorough accounting of the business's activities as well as a list of creditors and their respective debts at the meeting. After that, the liquidation committee and a new liquidator need to be chosen in the creditors' meeting. The creditors will decide on the final liquidator and the liquidation committee. The above procedural provisions show that in a creditors' voluntary liquidation procedure, the creditors have a greater right to decide than the shareholders and the liquidator and liquidation committee are ultimately responsible for creditors. Also, in a creditors' meeting, the directors have the duty to assist the creditors in verifying the company's accounts and determining the assets to be repaid to the creditors by the company. 'After the liquidator is appointed, the directors' powers will be significantly limited because when the liquidator takes over the company, the directors no longer control the company or anything it owns.'¹⁴ Their primary duty changes to assist the liquidator in the liquidation process and to provide the liquidator with the information about the company that they require.

4. Directors' Duties in the Event of Impending Insolvency

Based on the above discussion, the director takes on different responsibilities at different stages. When the company faces financial difficulties, the directors are expected to protect the interests of creditors as far as possible. Making a judgement on the company's current state and whether it can continue to operate or should be considered insolvent is an obligation that the directors must undertake. 'Davies Paul mentioned, the dilemma facing the directors of a company at risk of insolvency is whether to continue to run the company or file for insolvency proceedings for the company.'¹⁵ If the directors incorrectly assess the company's future prospects and choose to continue to operate the company, the interests of creditors will be greatly harmed. In order to protect the interests of creditors, 's214 of the Insolvency Act 1986 regulates that when a company enters into insolvency proceedings, the liquidator has the right to bring an action against one or more directors of the company for their involvement in wrongful trading.'¹⁶ Wrongful trading occurs when a corporation's directors make business decisions while knowing or should have known that there is no reasonable chance the firm would escape becoming insolvent and entering insolvent liquidation. About the duty of the liquidator, 'Richard Schulte cites that a liquidator's duty is to secure that the company's assets are got in, realised and distributed to the company's creditors first.'¹⁷ It can be seen that the interests of the creditor have the highest priority in the liquidation of a company. A company's assets will be realised by the liquidator when it is placed in liquidation. The funds are then utilised to properly satisfy the company's liabilities. Accordingly, an action for wrongful trading brought by the liquidator against the directors in liquidation proceedings can be seen as a protection of the interests of creditors.

[A]s Andrew Keay explains the original reason for the creation of wrongful trading is to handle the scenario when directors are aware that their business is struggling yet fail to take action to safeguard the interests of creditors.¹⁸

In addition to wrongful trading, the liquidator may bring another action against the directors in the liquidation proceedings for engaging in fraudulent trading.

[S]213 of the Insolvency Act 1986 regulates that if someone deliberately carries on the company's business intending to defraud the creditors of the company or the creditors of others, they will be liable for the loss of the creditors' interests.

¹² The Insolvency Rules 1986

¹³ Insolvency Act 1986, s 90

¹⁴ 'Liquidate your limited company' <<https://www.gov.uk/liquidate-your-company/what-happens-to-directors>> accessed 25 December 2022

¹⁵ Paul Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 EBOLR 301, 311

¹⁶ Insolvency Act 1986, s 214

¹⁷ Richard Schulte, 'Wrongful Trading: An Impotent Remedy?' (1996) 4 J Fin Crime 38, 40

¹⁸ Andrew Keay, 'Wrongful Trading and the Liability of Company Directors: a Theoretical Perspective' (2005) 25 Legal Stud 431, 433

Moreover, fraudulent trading involves a criminal offence, which may expose the person being prosecuted to criminal liability.¹⁹

It is clear from the legislative provisions that the central idea of fraudulent trading is the protection of the interests of creditors and the deterrence of shareholders from causing damage to creditors' interests through fraudulent forms. A classic example of a fraudulent transaction will be analysed next to discuss directors' duties.

[A]ccording to the *R v Grantham* [1984] QB 675, Mr Grantham was tried for fraudulent trading in violation of section 332(3) of the Companies Act 1948 (now section 213 of the Insolvency Act 1986). The jury found that they could find fraudulent intent on the part of Grantham if he had obtained credit knowing that his company would not be able to pay its debts as they fell due. Grantham then appealed against this. Ultimately, Lord Lane CJ, Boreham J and Stuart-Smith J dismissed Grantham's appeal. It is applied the House of Lords' case *Welham v DPP* [1961] AC 103, under section 332 (now section 213, Insolvency Act 1986), an intent to defraud was established on proof of intention to dishonestly prejudice creditors in being repaid.²⁰

Concerning the operation and management of companies, a company, being a legal entity, may be charged with a variety of crimes relating to its administration and functioning. However, the directors of the business are almost always involved. Directors of failing enterprises are frequently charged with fraudulent and wrongful trading. The legislation safeguards creditors who could suffer as a result of the company's liquidation. Prioritising the interests of creditors will ostensibly shield directors from becoming embroiled in liability claims in the face of a dilemma.

5. Conclusion

At a broader level, this essay was motivated by the observation that the duty of company directors often shifts considerably when a company faces insolvency. In order to assess the impact of corporate insolvency on directors' duties, this study analyses directors' duties at three different stages of a company's operations: when it is operating normally, when it is on the verge of insolvency and after it has entered insolvency proceedings. Through these analyses, as a company's operational difficulties increase until it becomes insolvent, the directors' duties will gradually shift towards protecting the interests of creditors. Based on the analysis of the different stages, we can see that as the company's insolvency progresses, the directors' powers are gradually reduced until the liquidator takes over the company. However, directors often know more about the company than the liquidator, as they were the company's top managers until it entered into insolvency proceedings. Suppose the liquidation is not directly related to the directors' performance. In that case, the legislation can increase the task of the directors to assist in the liquidation process, and this will be my future research on corporate insolvency and directors' duties. I believe with the development of legislation, the requirements for a director's responsibilities will become more perfect and humanised.

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