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Safe to trade?

There is nothing like potential personal liability to focus the attention. Personal liability and/or director disqualification can arise as a result of wrongful trading.

Wrongful trading, introduced under the Insolvency Act 1986, applies if 'at some time before the commencement of the winding-up of a company [a director or shadow director] knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation'. However, the court will not make a wrongful trading declaration 'if it is satisfied that after that point was first reached that person took every step with a view to minimising the potential loss to the company's creditors as he [or she] ought to have taken'. The facts which a director of a company ought to ascertain and the steps which he or she ought to take are determined by subjective and objective tests. In many cases the standard required of a turnaround practitioner in these circumstances is considerably higher than an 'ordinary' director.

As turnaround professionals are appointed by companies in some sort of distress, it is suggested that wrongful trading should always be considered - even if the directors are able, on good grounds, to conclude that it does not apply. The key trigger is obviously if, looking ahead, there may be 'no reasonable prospect' of the company ultimately avoiding insolvent liquidation.

Taking an objective view

Banks are keen to avoid making insolvency appointments. That puts the onus on directors to ensure they have the wherewithal to continue to trade. For example, the point may be reached where shareholders, bankers and directors consider that the appropriate thing to do is to sell the company, its business or assets. The first question to ask is whether this is realistically achievable in the timeframe for which funding is available. If it is not, the trading continues and a sale of the company is not achieved (eg only the business and assets are sold) then the company may end up in insolvent liquidation. The directors could then find themselves on the receiving end of a

wrongful trading claim unless they have taken every step with a view to minimising creditors' losses over the relevant period. In many of these situations, the commercial rationale for trading whilst seeking to achieve a sale may be compelling (eg because putting the company into an immediate insolvency procedure could have a depressing effect on price and cause job losses). That does not, however, provide an answer to the legal issues as the position of some creditors or stakeholders may improve at the expense of others.

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Directors and their advisers need to put on an insolvency hat in such cases. Ask, whilst a trade sale may result in a higher price, who benefits and who loses? If any and all money raised will go to pay the bank as secured creditor, then any credit incurred during the sale may have increased the exposure of trade creditors individually and/or collectively so that they may argue they are actually worse off. Of course, the position is exacerbated if the directors anticipate that negotiations are likely to end in a 'pre-packaged sale' by an insolvency practitioner.

Reviewing options

Creditors whose position may worsen over the relevant period should be identified and quantified. Next, take steps to avoid this happening. There could be a discussion with the company's funders to see whether they are prepared to commit to fund trading/new credit incurred from money they would otherwise be entitled to. That way new credit incurred may be secured and paid whether or not a sale proceeds and whether or not the company ends up in an insolvent liquidation.

The issue needs to be addressed with care. Issues affecting various stakeholders should be taken into account. The bank may, for

example, say that the company must trade within its existing facilities which may be difficult to do if 'new credit' incurred is effectively to be ring-fenced, but seasonal factors may mean that increased orders need to be placed with suppliers during the intervening period. Cash management techniques can be important but again this area can be a legal minefield. For example, there is a big difference between a creditor agreeing to postpone payment once the position has been explained and a creditor agreeing not to press for payment on a misleading basis (eg by being told 'the cheque is in the post'). Monitoring of accounts procedures is therefore also important.

Proper consideration of the issues and proper structuring to enable trading to continue are critical to avoiding personal liability and negative reputational consequences of a wrongful trading claim. In an extreme case if a disqualification order is made the turnaround professional could lose his or her livelihood. This is an issue for directors, shadow and de facto directors rather than shareholders, funders or others who may be happy to take the benefit of 'overtrading' at the directors' risk. Remember, as the provision applies to shadow directors and de facto directors as well as formally appointed directors, a turnaround professional may be caught whether or not he or she is formally appointed.

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