Matheson

Matheson Directors' Guidance Series

Companies in Financial Difficulties - Duties and Liabilities of Directors under Irish Law

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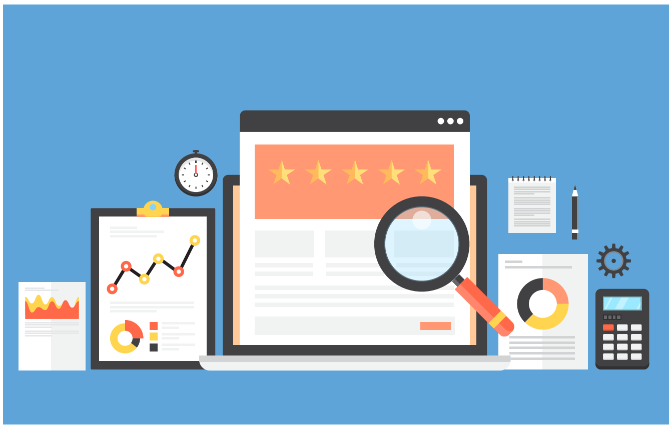

Introduction

This document summarises the principal duties and potential liabilities of directors under Irish law where a company is in financial difficulty.

The duties and potential liabilities summarised in this document will normally arise when a company is in financial difficulty or is insolvent based on a cash flow test or a balance sheet test.

In broad terms, the cash flow test looks at whether there are sufficient funds being received by a company to meet its liabilities as they fall due. This will be a concern if there is an immediate cash flow shortage with liabilities not being met or it may be an issue that is anticipated will arise in the future.

Under the balance sheet test, a company is insolvent if the value of its assets is less than the amount of its liabilities (including contingent and prospective liabilities). Insolvency on a balance sheet basis does not generally mean that the company should immediately stop trading but provides an indication to the directors that if a company was to stop trading, whether or not its business could be sold at a price that would enable creditors' claims to be met in full.

Problems may manifest themselves before a cash flow or balance sheet test issue arises if, for instance, a company is in breach of a borrowing or other covenant in its loan or other finance contracts. A breach of such covenants may be an indication that a company is in difficulty and may entitle the counterparty to enforce certain rights against the company, resulting in the company becoming insolvent, even if it was not already so. However, the counterparty might decide against exercising these rights, choosing instead to discuss with the company how the situation can be remedied.

Fiduciary Duties

Directors' principal fiduciary duties are codified under Irish company law in the Companies Act 2014. In total, eight principal duties have been codified. These are derived from case law and associated equitable principles which have been developed by the courts in Ireland over many years (see table).

The primary fiduciary duty for every director is to act in good faith in what the director considers to be the interests of the relevant company.

In a solvent company, the interests of the company are generally equated to the interests of the shareholders as a whole. This is based on the rationale that the shareholders' proprietary interests in the company entitle them, as a general body, to be identified with the company when questions of fiduciary duties arise.

Principal Fiduciary Duties of Directors

i. To act in good faith in what the director considers to be the interests of the company.

ii. To act honestly and responsibly in relation to the conduct of the affairs of the company.

iii. To act in accordance with the company's constitution and to exercise his or her powers only for the purposes allowed by law.

iv. Not to use the company's property, information or opportunities for his or her own benefit, or that of anyone else, unless (a) this is permitted expressly by the company's constitution or (b) the use has been approved by a resolution of the shareholders in general meeting.

v. Not to agree to restrict the director's power to exercise independent judgement, unless (a) this is expressly permitted by the company's constitution or (b) the director agreeing to such has been approved by a resolution of the shareholders in general meeting. However, where a director considers in good faith that it is in the interests of the company for a transaction or engagement to be entered into and carried into effect, the director may restrict his or her judgment to exercise an independent judgment in the future by agreeing to act in a particular way to achieve this.

vi. To avoid any conflict between the director's duties to the company and the director's other (including personal) interests, unless the director is released from his or her duty to the company in relation to the matter concerned, whether by the company's constitution or by a resolution of the shareholders in general meeting.

vii. To exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both (a) the knowledge and experience that may reasonably be expected of a person in the same position as the director and (b) the knowledge and experience which the director has.

viii. To have regard to the interests of the company's employees in general and its shareholders.

Where the directors become aware that a company is insolvent, the interests of the creditors intrude and become paramount for so long as the insolvency subsists. In such circumstances, the interests of the company can primarily be equated to the interests of the creditors - as the assets of the company are, in a practical sense, their assets pending a return to solvency.

Additionally, where a company is insolvent, there is specific judicial authority for the following propositions:

- the directors may have a duty to put the company into voluntary liquidation;
- where a company clearly has to be wound-up, the directors have a duty to preserve the company's assets so that they can be applied in discharge of its liabilities; and
- the directors have a duty not to make payments directly or indirectly to themselves to the detriment of the general and independent creditors.

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It is accepted that the duty to put the company into voluntary liquidation is a qualified duty and that, depending on the circumstances, it may be reasonable for directors to continue trading for a time when insolvent, to assess the situation and determine whether the company can trade out of its financial difficulties or otherwise return to solvency (e.g., by restructuring its financial arrangements).

The directors can also look at the option of putting a company into examinership, which is a court supervised rescue process similar to Chapter 11 of the Bankruptcy Code in the United States.

Fiduciary duties are owed to the relevant company (not to individual shareholders or third parties). This remains the case where a company is insolvent, and creditors do not have a direct right of action against a director for breach of fiduciary duties.

Accordingly, in general terms only the relevant company may take an action for breach of duty against a director, although on a liquidation, this power may be exercised by the liquidator.

In circumstances where a breach of duty is proven, a director may be required (i) to account to the company for any personal gain made from the breach and (ii) to indemnify the company for any loss or damage resulting from the breach.

The High Court of Ireland is empowered to relieve a director from personal liability if he or she has acted honestly and reasonably and where the court believes that, in the circumstances, the director ought fairly to be excused.

Fraudulent and Reckless Trading

General

In addition to potential liability for breach of fiduciary duties, the Companies Act 2014 contains two statutory civil remedies whereby directors and certain other persons might also be held personally liable. These are the civil remedies for fraudulent trading and reckless trading, which may be actioned when a company is in liquidation or examinership.

While only a company (acting through a liquidator in its liquidation) can bring an action for breach of fiduciary duties, a liquidator, an examiner, a receiver or a creditor may bring a fraudulent or reckless trading action against a director.

Fraudulent Trading

A director or any other person may be held liable for fraudulent trading if he or she was knowingly a party to the carrying on of any business of the company with intent to defraud creditors or for any fraudulent purpose.

Reckless Trading

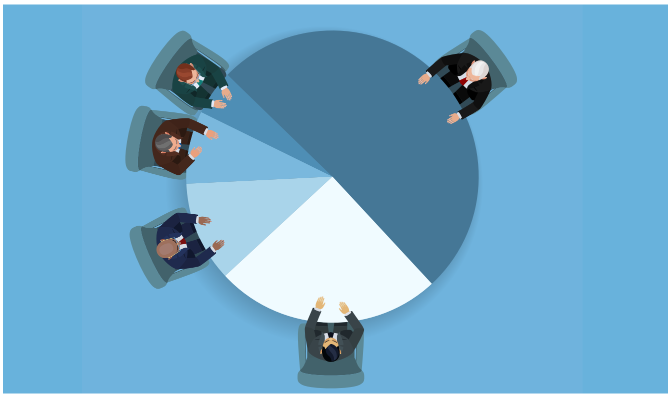
Of broader relevance is that a director may be held to be personally liable for reckless trading where that director was knowingly a party to the carrying on of any business of the company in a reckless manner.

A director shall be deemed to have been knowingly a party to the carrying on of any business of the company in a reckless manner, if:

(i) he or she 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 or her position, he or she ought to have known that his or her actions or those of the company would cause loss to the creditors of the company, or any of them; or

(ii) he or she 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 other debts (taking into account contingent and prospective liabilities).

In deciding whether to impose liability in favour of a particular creditor, a court is obliged to have regard to whether the creditor was, at the time the debt was incurred, aware of the company's financial state of affairs, and notwithstanding such awareness, nevertheless assented to the incurring of the debt.



Restriction and Disqualification Orders

General

Apart from the risk of incurring personal liability, a director or former director of an insolvent company may be made subject to a restriction or disqualification order.

Restriction Orders

A restriction order is an order precluding a director, for a period of five years, from being appointed or acting in any way, whether directly or indirectly, as a director or secretary or from being concerned or taking part in the promotion or formation of an Irish company unless such company meets certain minimal capitalization thresholds.

Application for a restriction order made be brought by the Director of Corporate Enforcement, a liquidator or a receiver. Where such an application is brought against a director, the court is required to make a restriction order unless the director satisfies the court that he or she has acted honestly and responsibly in relation to the affairs of the company and that there is no other reason why it would be just and equitable that he or she should be subject to the restriction.

As an alternative to bringing an application for a restriction order, the Director of Corporate Enforcement may accept a voluntary restriction undertaking from a director.

Disqualification Orders

A disqualification order is an order precluding a director from being appointed or acting in any way, whether directly or indirectly, as a director or secretary or from being concerned or taking part in the promotion or formation of a company for such period as the court determines.

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Application for a restriction order made be brought by a much broader category of persons than can bring application for a restriction order, including the Director of Corporate Enforcement, the Director of Public Prosecutions, a liquidator, an examiner, a receiver, a creditor and an employee. A court may also determine to impose a disqualification order on its own initiative.

In practice, applications for disqualification orders are not that common and are reserved for situations involving fraud, criminal activity or other serious misbehaviour.

Vulnerable Transactions

Directors should also be aware that if a company enters into certain types of transactions within specified periods before an insolvent liquidation, a liquidator may be able to apply to court for an order to unwind such transactions, or require some other appropriate remedy. These include (i) transactions entered into in the previous 6 months which are considered to constitute an unfair preference in favour of a creditor (with the time being extended to 24 months if the creditor is a connected party) and (ii) certain types of transaction whereby the company grants security or collateral over its assets in the form of a floating charge.

Practical Guidance

As soon as the directors of a company become aware that the company is in financial difficulty, they should seek professional advice, principally from the company's lawyers and financial advisers. As a starting point, the directors can seek advice from the firm of accountants that acts as the company's auditor (assuming that the firm has no conflict of interest in advising in this dual capacity).

In order to assess the extent of the problem, the directors will, at the very least, need an up-to-date cash flow statement, whatever recent monthly or other management accounts are available and appropriate projections, incluiding as of trading prospects, cash flow and financial covenant compliance. Any actual or potential breaches of covenant or events of default in loan or finance contracts should be brought to the immediate attention of the directors. Where guarantees have been given (e.g., in respect of group debt), the likelihood of a default occurring elsewhere in the group and the guarantees being called requires to be assessed.

The full board of directors should meet as soon as possible after the preliminary assessment of the position. If any of director cannot attend in person, he or she should participate by telephone subject to being allowed to do so under the company's constitution. The meeting should consider the circumstances that gave rise to the difficulties and the company's financial condition. Decisions then need to be made as to what the company should do in the light of the circumstances and the professional advice. A detailed board minute should be prepared.

Further board meetings should be held to continue to review the situation and the options available to the company and to consider appropriate contingency planning. These may need to be held frequently if the situation is fast moving or changeable. Again detailed minutes should be prepared after each board meeting. As a court or liquidator will be reviewing the situation in retrospect, a full paper trail is important to enable the directors to show that they assessed the situation properly, took appropriate advice on a regular basis and, insofar as they considered it appropriate, acted in accordance with such advice in order to fulfil their duties to the company and avoid trading in a reckless manner.

In order to mitigate the risk of liability on a subsequent liquidation or examinership, the critical issue for each director is to be able to demonstrate that he or she has acted honestly and reasonably in discharge of his or her duties and in the management of the company's affairs during the relevant period.

The directors should be particularly vigilant of (i) any worsening in the overall position of creditors and (ii) any diminution in the assets of the company. They should also seek to ensure that transactions involving the sale or transfer of any assets are for market value and sanctioned by the board and that no such transaction is entered into other than on an arm's length basis without first taking legal advice.

To the extent possible, the directors should look to keep creditors apprised of the financial state of affairs of the company.

Contacts

For more information, please contact Fergus Bolster, Emma Doherty or another member of the Matheson Corporate Department.

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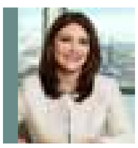

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