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The role of directors in a restructuring – is it getting tougher?

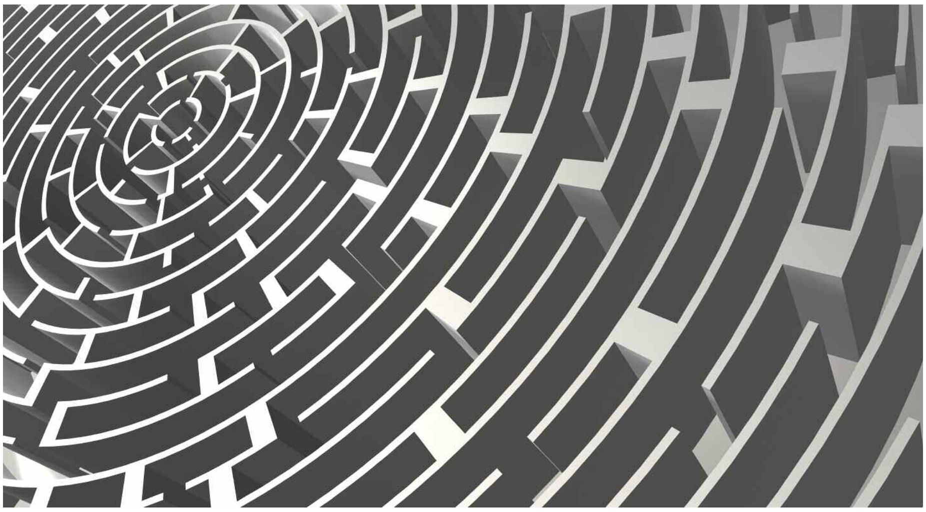
Challenging economic times have generated innovative techniques and solutions for restructuring companies. At the same time, legislation focused on preservation rather than insolvency of financially troubled companies continues to evolve across Europe. Clifford Chance experts consider the role played by the directors of struggling companies, and whether recent developments make their jobs even harder.

Directors are increasingly challenged to develop rescue plans for struggling businesses outside of insolvency, as we witness a cultural shift across Europe toward restructuring financially troubled companies wherever possible. But doing so is neither quick nor easy, particularly as directors maintain a responsibility for the business that exists beneath the challenged capital structure deep into the grey zone between solvency and insolvency, which can often be overlooked.

With the potential sources of personal liability also increasing materially for directors over recent years, this paper looks at directors' duties, responsibilities and risks in the face of a restructuring, and considers why such situations are currently getting tougher to navigate, both in the UK and beyond.

The role of the board in a restructuring

The duties and fiduciary responsibilities of directors are now in English law, in common with continental law, primarily codified in companies legislation and supplemented and supported by case law. Fundamentally, directors have a duty to promote the success of the company and, in particular, with regard to its shareholders, as well as other stakeholders including employees, and those duties remain in place in the event of financial difficulties affecting the company.



There is often a shift in those duties for directors of financially troubled businesses, who in the UK must have particular regard for the interests of creditors once problems hit. Adrian Cohen, partner in Clifford Chance's Insolvency and Restructuring group, says: "Those duties are subject to an over-riding concern to protect the interests of creditors once a company is in financial difficulty. That is not to say that the interests of other stakeholders are no longer relevant, the point is they are subject to the interests of the creditors."

Under insolvency legislation, there are several sources of liability for directors, including the first challenge of defining at what point a company is in financial difficulty or in English parlance 'unable to pay its debts'. This can be determined

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Adrian Cohen, Clifford Chance partner, London using a balance sheet test or a cash flow test, with different tests used in different countries, and the determination has implications for whether the business can continue to trade, among other things.

From the English law perspective, the decision for directors on whether or not to cease trading comes down to a question on wrongful trading, because once a company has failed and gone into liquidation, had a director known beforehand that there was no reasonable prospect of avoiding insolvent liquidation, they may become liable to compensate the estate for any losses caused by the continuity of trading. The only defence available is that the director had taken every step to minimise potential losses to creditors.

Another source of liability in the insolvency legislation is in the adjustment of prior transactions, should it be proved that, ahead of liquidation, some creditors were given preferential treatment or that assets were transferred for less than their true value. And then there is the risk of fraud and misfeasance claims, looking at whether directors have acted in accordance with their duties, or whether there was any deliberate misallocation of assets.

The role of the board is to work with stakeholders to develop and implement a solution that respects their interests and, to the extent possible, has their support.

There are two key areas of risk, with the first being around timing, as filing for insolvency too late by pursuing a lost cause can be dangerous, as can filing too early before all options have been fully tested. The second challenge is in maintaining fairness of approach to different creditors and stakeholders.

Increasingly, boards are turning to the services of corporate restructuring officers for support, who can add the necessary experience of restructuring situations. This is particularly the case in pan-European situations, where the growth of European pre-insolvency rescue procedures is extending the grey zone for directors and increasing risk.

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Tougher times for directors in the UK

Several legal developments have made it tougher for directors in the UK to deal with restructurings of troubled companies. The first is the expansion of the so-called *West Mercia Safetywear v Dodd* principle, which concerns the way in which the duties of directors are altered when a company is in financial difficulty, to have primary regard to the interests of creditors. A number of recent cases appear to expand this principle and could impose liability on directors where they can be argued to have given preference to one creditor over another, rather than having regard for the interests of creditors as a class.

Secondly, historically fraudulent and wrongful trading actions have only been available to liquidators as a means of recovering assets from directors, but with effect from October 2015, these actions are now also available to administrators.

Third, insolvency office holders are now able to assign wrongful trading and other recovery claims to third parties. In the past, few cases have seen the light of day, but if they pass into the hands of well-funded and aggrieved litigants, more cases may now be pursued.

Another change is the potential shift in the burden of proof applied when a 'minimising loss' defence is used in a case of wrongful trading liability. The only defence to a wrongful trading claim is that a director has taken every step to minimise losses, and in a recent case, it was found that the burden of proof for that defence lays with the directors themselves.

Further, a recent case has confirmed the extra territoriality of fraudulent, and possibly wrongful, trading claims, exposing directors of English companies to liability in respect of wrongful actions that take place abroad. And finally, with effect from October 2015, there is now a power under the Company Directors Disqualification Act for compensation orders to be made against directors.

Despite all this, there have been some positive developments for directors, with

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the recent confirmation that wrongful trading liability is compensatory, not penal, for example. In one case, the judge was prepared to give the directors credit for the fact that they had not acted dishonestly, acknowledging that, while they got it wrong, they were well-intentioned.

Secondly, the government recently commissioned an independent report into the pre-pack administration procedure, called the Graham Review, which makes recommendations for reform. Amendments made in November 2015, which are aimed at improving accountability and transparency, should work in favour of directors, who have often found themselves in the firing line on pre-pack challenges.

Iain White, partner in Clifford Chance's Insolvency and Restructuring group, concludes: "There are not many cases of instances where directors have incurred wrongful trading liability in restructuring situations. So whilst the risks are clearly increasing, with the right advice it should still be possible for directors to navigate those risks."

Challenges facing directors of listed companies

When considering the challenges for directors of companies with listed debt or equities, the issues get even more complex. Patrick Sarch, partner in Clifford Chance's Corporate practice, says: "There is a real tension between regulatory obligations under the listing rules, disclosure and transparency rules to provide real-time information to the market and the need for equality of information to investors on the one hand; and a company seeking to solve a problem before it has to announce that it has a problem on the other."

He adds, "A listed issuer has to announce inside information as soon as possible, within hours or minutes of an issue arising, and there are limited circumstances in which they can delay disclosure."

A company can delay, so as not to prejudice its legitimate interests, if the delay would not mislead the public, a duty of confidentiality is owed by the person receiving the information, and the company can ensure confidentiality is protected. A 'legitimate interest' is defined very narrowly (though the regulators are looking at this rule at the moment), to include ongoing negotiations where the outcome would likely be impacted by disclosure.

The rules do not allow a company to delay so that it can find out more information if, for example, financial irregularities are uncovered but the extent of them is not yet known, or if the company's position in subsequent negotiation would be jeopardised by the disclosure.

Under a special rule, a bank does have a legitimate basis on which to delay disclosure of inside information concerning liquidity support by the Bank of England or other central bank, however.

Listed company directors and stakeholders also need to be mindful of key thresholds when considering implementation of restructuring plans, most notably the threshold for a mandatory bid obligation, where an immediate cash offer must be made to all other shareholders by any person acquiring interests in shares carrying more than 30% of the voting rights of a company. Acquisitions by persons acting in concert are aggregated, but in the context of a new issue the mandatory bid obligation can be waived by an independent vote at a shareholders' meeting, normally in conjunction with other necessary approvals, for example to issue shares.

When it comes to listed companies directors' liabilities, the chief concern is usually handling inside information, along with the provision of responsibility statements in any prospectus or circular. D&O insurance policies offer liability cover for directors to protect them from claims that may arise from the decisions and actions they take within the scope of their duties, and separate insurance is available for liabilities arising from a prospectus. Indemnification by the company is also often available for directors in claims brought by third parties.

Issues for directors of pan-European businesses

Large corporates often have subsidiaries in overseas jurisdictions, and that can have a big impact on directors' responsibilities, particularly if directors also sit on the boards of subsidiaries in other countries. For the most part it is clear that directors must take into account the interests of the company, but rules vary across Europe as to how much directors must have regard to the interests of creditors in times of financial difficulty. In English law there is a shift from the interests of shareholders to creditors, as there is under Dutch law, but that is not necessarily the case in Spain and elsewhere.

Likewise, there are different timing pressures in different jurisdictions, such that in Germany it is necessary to file for insolvency within 3 weeks of triggering

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Ilse van Gasteren, Clifford Chance counsel, Amsterdam certain insolvency thresholds, for example, which can impact the timing of a cross-border restructuring significantly. Such challenges highlight the importance of contingency planning, particularly in cross-border structures.

Directors find themselves in a unique position if a company decides to shift its centre of main interests (COMI) so as to take advantage of insolvency rules in another state. Such a shift does not change the fact that the company is still incorporated in its original jurisdiction, so directors then need to take into account their duties under both sets of legislation.

As the expansion of pre-insolvency procedures across Europe continues, the role of directors in a restructuring may get even more complex. Ilse van Gasteren, counsel in Clifford Chance's Banking and Finance practice in Amsterdam, says: "There will be more pre-insolvency restructuring options available in more jurisdictions, so directors will likely need to look into all those options in the interests of the company. The directors may prefer one option over another while other stakeholders may have different preferences. So while it is good to have more options, it may present further challenges for directors."

The European Commission is shortly to produce a study on the cross-border issues that arise around directors' liability, which it last did back in 2013. After that publication there were several rule changes implemented across member states, so it is likely we can now expect further changes on the horizon.

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