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Directors duties in relation to local authority trading companies and special purchase vehicles

Some prudent steps that directors should take to minimise their risk of being personally liable in an insolvency situation.

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The Covid-19 pandemic has had a considerable impact on the already financially stretched public sector and we have seen an increase in our clients seeking advice around potential insolvency, particularly in relation to local authority trading companies (LATCs) and special purchase vehicles (SPVs) where councillors and officers serve as directors. We have therefore outlined below some prudent steps that directors should be taking to minimise their risk of being personally liable in an insolvency situation.

Directors have various duties that are owed to those companies, including those codified in the Companies Act 2006. Importantly, in a distress situation, these duties change, and directors will need to shift their priorities to ensure they are complying with the duties placed on them by the Insolvency Act 1986. In particular, in the event of insolvency, a director's duty to promote the success of the company shifts so that, instead, the interests of the company's creditors become paramount. In this situation, directors must protect the value of the company's assets and minimise losses to creditors as far as possible. This also includes the duty to avoid causing the company to make a preference and/or a transaction at an undervalue.

A company is insolvent (unable to pay its debts) if it either the value of its assets is less than the amount of its liabilities (i.e. balance-sheet insolvent), or if it is unable to pay its debts as they fall due (i.e. cash flow insolvent). There are various ways to assess whether a company is unable to pay its debts, but the most common is if the company has not paid, secured or settled a claim for a sum due to a creditor exceeding £750 within three weeks of having been served with a statutory demand.

A company that might be facing insolvency, or is balance-sheet insolvent, can continue to operate but it is important that great care is taken when deciding how to proceed. Advice should be sought from an insolvency professional at this stage. Directors of LATCs/SPVs must also be mindful of their duty to avoid conflicts. Often individuals have to balance at least two roles, one being a representative elected member or employee of the shareholder authority, and the other being a company director of a council owned/controlled company. Conflicts of interest between the relevant duties owed to each body therefore need to be carefully managed to prevent problems arising for the individuals concerned and the bodies they represent.

Although the company itself will normally be liable for its debts, directors can face personal liability in the event of any fraud, misfeasance or other misconduct. In addition, directors could be personally liable to make a contribution to the company's assets if they continue to trade when they knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation or administration. This is known as wrongful trading. It is important to note that the UK Government has now reintroduced the temporary suspension of wrongful trading measures from 26 November 2020 until 30 April 2021, pursuant to the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and Extension of the Relevant Period) Regulations 2020. The suspension was originally introduced in March 2020 under section 12 of the Corporate Insolvency and Governance Act 2020 but expired on 30 September 2020.

Whilst some comfort can be taken from the reintroduced suspension of wrongful trading (removing one threat of personal liability which directors may face), the actions of directors could still be subject to scrutiny if, ultimately, insolvency proceedings are later entered into. Therefore, directors must continue to adhere to their other statutory duties whilst continuing to trade the business. There has been no relaxation of directors' fiduciary and statutory duties, nor of the rules on fraudulent trading, and so directors are well advised to continue taking all of the usual precautions. Incurring debts in the full knowledge money will run out, with no reasonable prospect of a solvent solution, may still mean directors could face consequences for breaching their statutory duties or indeed for fraudulent trading, if the circumstances merited such.

Directors can help protect themselves by taking external advice, regularly assessing the options open to them and recording the reasons for all decisions made as a consequence of that advice.

If caught early enough, insolvency may be prevented or foreseen in its early stages and steps taken to rectify the causes. Directors should consider taking the following pre-emptive measures to help them recognise and react to the risk of insolvency as early as possible:

- receive and review regular and robust financial management information and record any significant decisions of the board;
- consider appropriate business efficiencies to save money where and when appropriate;
- seek funding/income from multiple sources to insulate against the risk of over-dependence on any one source;
- incorporate adequate risk/reserve policies when budgeting to avoid any unforeseen liabilities taking you by surprise; and
- put in place an insolvency contingency plan so you have a broad idea of your options and who to call in a crisis.

If insolvency is unavoidable, it may still be possible to rescue or restructure a business such as through administration or a company voluntary arrangement rather than liquidate it. Both mechanisms can provide much-needed breathing space to allow directors to consider their options. If a company cannot be rescued, then liquidation (initiated by the creditors or the members themselves) is usually the last resort.

If you have any questions or would like some assistance, please get in contact with Chloe Poskitt on 0115 934 2058 or by email.

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