INSOLVENCY UPDATE

MESTON REID & Co
CHARTERED ACCOUNTANTS

This is the first Update since the passing of the late Queen Elizabeth II and it is appropriate to pay tribute to, and thank her for, her long reign as she helped to guide our country for more than seventy years. After a period of national mourning and a truly memorable State funeral, all eyes will be on King Charles III. We wish him every success.

Introduction

Base rate is now 2.25% and the Bank of England's inflation target is 2%, whilst the UK inflation rate in August was recorded at 9.4%. To the more mature reader, it is hard to believe that the inflation genie, once escaped from the bottle, can be recaptured quite as quickly as the media seem to suggest. Savers enjoy an increase in interest rates, but it can cause misery to mortgage holders who have borrowed as much as they could based upon a very small interest rate and face a significant increase when their current fixed term mortgage expires. The increasing price of energy will force most consumers to rethink their expenditure pattern and, for example, some items deemed to be essential are moved to the non-essential list.

Some help has arrived in the form of a cap on energy prices (individuals as well as businesses). Further, the Scottish Government has decided that tenants will not be subject to any rent increase until 1 April 2023 (at the earliest) with no risk of eviction if rent is not paid. Spare a thought for the landlord who may be fully borrowed and relies upon regular rent in order to keep his financial obligation under control. Mixed messages.

Faced with this backdrop, it is unsurprising that the Meston Reid & Co insolvency team is witnessing an increase in enquiries from both individuals and businesses : perhaps an early indicator that, without further significant Government intervention, insolvency numbers may well increase in the coming months.

Is a company moratorium the short term answer?

The Corporate Insolvency and Governance Act 2020 came into force during that year and, amongst other things, introduced the concept of a moratorium. This is designed to allow financially distressed companies an initial breathing space of up to forty days, and stops enforcement action by most creditors whilst the company organises its affairs to implement a viable rescue package. A licensed insolvency practitioner must act as the monitor, and the process cannot proceed unless the proposed monitor is prepared to certify that the moratorium is likely to result in the rescue of the entity i.e. the whole company rather than a part thereof. Also, the management (who remain in place throughout) must certify that the company is currently, or likely to become, unable to pay its debts as they fall due.

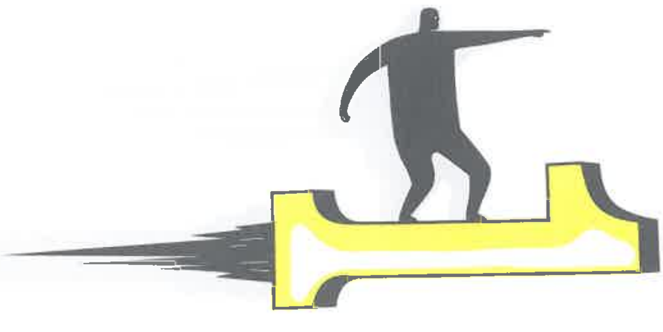
A moratorium is approved by court, which makes it more robust than a company voluntary arrangement which can be overturned by creditors at an early stage in the process.

For smaller companies, a moratorium is quite expensive at the outset, particularly when cash is in short supply. Typically, because directors tend to ask for help when they are at their wits end and have tried everything they deem appropriate to keep the business afloat, it is often too late for a moratorium to be a practical option.

Company in choppy waters? Directors take care

When consulting with a director about company matters, it is quite common for words such as "me" and "my business" to be used because a director often thinks/acts as if the entity is him and often requires to be reminded that a company is a separate legal entity. Of course, being a separate entity is often good news because it means that, generally speaking, directors, shareholders and employees are not liable for a company's debts and other obligations, although there are instances where that can change.

R3, the UK insolvency trade body, issued guidance notes earlier this year about being a director and the personal liability that can arise therefrom. With due regard to the provisions of the Companies Act 2006, R3 highlights some key statutory duties :



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1. Act within powers : a director must act within the powers assigned in accordance with the company's articles of association, and only exercise these powers for their proper purpose. We are already seeing how this can be abused with regard to bounce-back loans. The Director Disqualification Unit is already pursuing a number of individuals who accessed money under the Covid-19 scheme, and used it for personal rather than business purposes.

2. Promote the success of the company : as one might imagine, a director must act in good faith and in a way that is most likely to promote the success of the company for the benefit of all stakeholder groups. This means that a director should have due regard to the interests of creditors when he knows that a company is, or is likely to become, insolvent. Thus, if a director thinks that the company is in financial difficulty and unlikely to recover such that all creditors will be paid, there is a duty to act sensibly rather than borrow recklessly and take inappropriate risks.

3. Exercise independent judgement : whilst a director may delegate certain tasks to others with specialist expertise, every director must exercise his own independent judgement in deciding what to delegate and whether to follow the advice of whoever provides it. One cannot let a company sink and try to point the finger at external advisors. The buck stops at the director's desk.

4. Exercise reasonable care, skill and diligence : the director owes a duty of skill and care to the company. Someone who has experience in a certain industry is more likely to be a director of a company in that sector rather than from a completely different sector. Simply "hoping for the best" is not good enough.

5. Avoid conflicts of interest : a director must avoid situations where there is a direct or indirect interest of his that conflicts with the interests of the company. For example, if a company is experiencing financial difficulty, a director might be tempted to sell assets to either himself or a related party at undervalue in order to retain ownership once the company fails, or perhaps denude the company's bank account by settling his loan account to the detriment of third party creditors.

6. Declare interests in proposed transactions : a director must declare any direct interest in a proposed transaction with other directors. There is no excuse for not knowing the law and acting incorrectly.

Of course, a director will have to consider the provisions of the Insolvency Act 1986 in terms of the possibility of being guilty of either wrongful trading or fraudulent trading, which may impose personal liability on the director once a liquidator has been appointed. Further, a director will need to be careful about any third party obligation such as a bank or supplier, in whose favour such director has signed a personal guarantee. It is not unusual for a director to favour payment of those for whom he has signed a personal guarantee e.g. the bank, which, of course, can contravene the statutory duties detailed above.

The Finance Act 2020 can make a director personally liable for tax debts and of course, he can be pursued for unpaid taxes when the liability might arise from being involved in an activity that purposely seeks to avoid tax, or is deemed to be tax evasion.

Should liquidation incept, the implications of the Company Directors Disqualification Act 1986 also require to be borne in mind in terms of how a director acted prior to liquidation e.g. filing accounts and other statutory returns, leaving one creditor largely unpaid (typically HMRC), taking deposits without being able to provide the goods/services ordered, abusing a bounce-back loan, extracting a substantial salary that was disproportionate to the duties undertaken, drawing dividends in excess of retained profits, not keeping proper records etc.

Clearly, any director who thinks that there may be trouble ahead should seek experienced advice at the earliest opportunity because failure to do so could result in more that just the loss of the company.

GDPR

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Conclusion

This Update is provided for general interest purposes and does not purport to offer definitive advice. Thank you for taking the time to read this Update and feel free to pass it to anyone who you think might be interested in reading it.

Meston Reid & Co

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