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Briefing

Directors of Companies in Financial Difficulty

INSTITUTE OF DIRECTORS IN IRELAND

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Under the Companies Act, it is the responsibility of the directors to ensure their company keeps proper books and records to enable "at any time the assets, liabilities, financial position and profit or loss of the company to be determined with reasonable accuracy".

This briefing looks at points to be considered for determining the health of a company, the duties of directors when insolvency is foreseeable, the types of sanctions that can apply to directors who are found to have acted in ways contravening the interests of these duties, and ways in which a board might act in order to mitigate these risks.

Determining the financial health of a company

Two ways to determine the financial health of a company are the balance sheet test and the cash-flow test. The balance sheet test examines whether a company can discharge its total liabilities after realising all of its assets: where a company cannot discharge its total liabilities, it is insolvent.

Under the cash-flow test, the value of a company's assets in relation to its liabilities is irrelevant: a net positive balance sheet is irrelevant if the company cannot pay its debts as they fall due. In other words, the test assesses whether the company's cash-flow is sufficient to sustain its on-going operation.

If either of these tests indicates the prospect of insolvency, the directors of the company must consider the basis on which the company may continue to trade, based on financial and legal advice. The decision to trade must be kept under constant review.

Duties of directors of a company in financial difficulty

Ordinarily, the principal duties of a director are owed in the first instance to the company itself. However, once insolvency becomes a real possibility for the company, the primary duty of the directors shifts in favour of the company's creditors.

Do not assume that the safest course is to cease trading. Steps should be taken to preserve assets and to minimise loss to creditors. Directors may be faulted just as much for a premature cessation of trade as for continuing to trade while insolvent. A decision to continue to trade while insolvent risks personal liability for the directors and should only be taken based on clear legal and financial advice which the board carefully documents and reviews frequently.

Such potential personal liability of a director may be in respect of matters such as fraudulent or reckless trading. Further, the directors may be subject to restriction or disqualification orders.

Steps which can be taken to mitigate risks

A board should keep detailed records of the commercial basis of decisions that are taken when the company faces the prospect of insolvency so that the directors will be able to demonstrate the basis for their honest beliefs at the relevant time and their view of the reasonable grounds for taking those decisions. Any commercial decision that the company should continue to trade although it faces the prospect of insolvency, or is insolvent, should always be informed by the appropriate professional advice and that advice should be recorded. Ensure that accounts are being properly prepared and are up to date.

The board should review its costs and take whatever steps may be appropriate to reduce them. Payments to connected parties should be avoided. Annual returns and tax filings should be kept up to date and any tax liabilities should be paid to Revenue as they fall due.

Keeping major creditors informed and enlisting their support for the continued operation of the company is likely to be of benefit to the general body of creditors and will assist the directors to show subsequently that they took every step available to minimise loss to creditors. However, such liaison with any creditor must never involve unfairly preferring any creditor.

Further information is available from

Garreth O'Brien
Partner
+353 1 607 1489
garreth.obrien
@mccannfitzgerald.com

Michael Murphy
Partner
+353 1 611 9142
michael.murphy
@mccannfitzgerald.com

Alternatively, your usual contact in McCann FitzGerald will be happy to help you further.

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Institute of Directors in Ireland, Europa House, Harcourt Street, Dublin 2
01 411 0010 | info@iodireland.ie | www.iodireland.ie

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