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## Recovery matters



### The Twilight Zone – a director's dilemma

Despite its infamous TV cultural status, there is no dictionary definition of the term the "Twilight Zone". The Twilight Zone is, however, widely used to describe a time when directors may be trading a company which has known financial difficulties and are trying to avoid the onset of formal insolvency. This may be a period when a company has insufficient cash to pay its debts as they fall due - one of the key tests of corporate insolvency – or can be attributed to a budgeted cash shortfall in the coming months ahead.

This Twilight Zone continues until such time as the company is put back on the straight and narrow. This usually follows a period of restructuring and refinancing. In some cases, companies in the Twilight Zone cannot recover being incapable of rescue and have to be put into some kind of formal insolvency procedure. The fact that the company goes into formal insolvency triggers the prospect of personal liability on directors in relation to preferences, transactions at undervalue, wrongful trading and the like – and directors may face personal liability for the Company's debts if they don't behave correctly during the Twilight Zone. Basically, the period prior to liquidation can be scrutinized to ensure that directors have not crossed certain boundaries, and the benefit of hindsight is, regrettably, not afforded to them. To trade in the Twilight Zone must, therefore, carry a huge risk to directors, in the event that the Company is not ultimately rescued.

### Twilight trading

Although It is not illegal a company to continue to trade in the Twilight Zone and, indeed, in some circumstances, it may be the right thing to do, both for the company and its creditors, much will depend on the outcome, which will always be unknown to directors when they enter the Twilight Zone. It is important that directors fully understand the lawful limits of trading in the Twilight Zone and what their own personal duties as directors are, and their obligations that arise from such duties. Directors must seek a successful but realistic outcome for the company and its stakeholders whilst at the same time protecting the interests of the creditors of the company in the event that formal insolvency proceedings turn out to be unavoidable. As previously mentioned, such an outcome will usually lead to intense enquiries into the directors' conduct and in some cases this can lead to disqualification from acting as a director and personal liability for some or all of the company's debts. Indeed, directors will be accused of wrongful trading should the debts of the Company increase in the Twilight Zone, even if there was a good chance that their actions would benefit creditors. Directors must take *all steps* to avoid creditors being worse off, and that places a heavy burden on any director.

***“ Directors must take all steps to avoid creditors being worse off, and that places a heavy burden on a director”***

### Directors' duties under the Companies Act 2006

One of the most important duties of directors is to “promote the success of the company for the benefit of its members”. The act goes on to say that in doing so, they must have regard to the likely long term consequences of any decision; the interest of employees; the need to foster relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; and the desirability of the company maintaining a reputation for high standards of business conduct.

***“In the Twilight Zone, the duty to promote success for shareholders is replaced by a duty to act in the best interests of creditors.”***

Given this change in duty, directors may not be criticised too much in relation to conflicts between the various stakeholders as, for example, some redundancies may be required to save the business, albeit may not be in the best interests of the employee group as a whole – although you could argue that some redundancies may ultimately avoid the prospect of whole scale losses of jobs, should the business fail.

## Some practical steps

As soon as directors know the company is about to enter or is already trading in the Twilight Zone, directors must be mindful of the following (albeit not exhaustive) matters:

- Take expert professional advice from lawyers, accountants and insolvency practitioners
- Implement systems to ensure that what needs to be done is done. Directors are solely responsible for the running of the business and there will be no defence if delegated duties fail to be carried out
- Keep full, up to date financial information including current management accounts and cash flow statements and prepare regular forecasts (profit & loss and cash flow) for the foreseeable future
- Hold regular board meetings including all directors and increase frequency when cash flow is most problematic.
- Accounting information and forecasts should be discussed in detail in conjunction with advice received.
- Keep detailed records of all discussions and note specific reasons for continued operations and why it is considered that there is a reasonable prospect of avoiding insolvent liquidation
- Maintain regular contact with bankers or other funders, and key suppliers, creditors and sub contractors to ensure their support continues

- Pay Crown debts promptly or negotiate a formal payment arrangement
- Confine payments to those which ensure survival, ie those enabling continuance of key supplies and services.
- Avoid payments which could constitute a preference.
- Record all strategic decisions.
- Take care not to infringe legislation in relation to preferences, transactions at undervalue and granting of floating charges when raising funds or causing the company to repay guaranteed debts or disposing of assets
- Consider regulatory issues if company is publicly listed
- Take advice before resigning as a director as this may lead to allegations of failure to take steps to minimise the loss to creditors

## Conclusion

The current economic client is bound to have a continued impact on business in 2010, particularly on small and medium-sized owner-managed businesses, which have probably not yet felt the full force of the recession.

***“Directors need to take care in their decision making and ensure they obtain advice from their accountants and from insolvency practitioners, where appropriate, so to minimise personal liability in the Twilight Zone”.***



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