OPUS
RESTRUCTURING & INSOLVENCY

Directors: When is your company considered to be insolvent?

Is it denial or resilience which inspires directors to continue trading past the point when a company should in essence stop trading and call for professional assistance?

Each director will have their own view on that set of circumstances, but note carefully, insolvency legislation governs this precise scenario.

In order to avoid personal liability or sanctions, directors should seek the appropriate advice as to what steps are required going forward. A solicitor or accountant should be able to provide assistance, but an insolvency practitioner will formulate the most appropriate strategy bearing in mind the legislation and the options available, considering individual circumstances.

Taking advice early helps to keep all options on the table and maximise your chances of a successful recovery or restructuring.

However, your company may be trading whilst insolvent without you even realising it. There are two main tests that define if you are insolvent. The importance of these tests is that they are the legal tests and define the point of insolvency and when your duty of care moves from being owed to members to being owed to the creditors first.

If you mishandle creditors and let the financial position deteriorate, you can be liable for wrongful trading or a misfeasance claim. A misfeasance claim is a catch-all claim for breach of your duties as a director under the Companies Act, sometimes brought by a liquidator to recover funds for creditors. You should always act with those duties in mind.

Test 1: Cash flow

The inability to pay your debts as they fall due for payment.

Some of these points below can be indicators of cash flow difficulties;

- You are being pursued for payment by various creditors and cannot afford to pay them all on time.
- Receiving multiple Statutory Demands for payment with Sheriff Officers at the door
- You have asked to defer tax payments such as PAYE or VAT.
- Increasing your overdraft or borrowing constantly on, or just below your bank limit.
- You consider a sale and leaseback of certain assets to raise funds
- A significant increase in costs or turnover will drain available cash
- A significant decrease in turnover, below breakeven will lead to cash under strain

At a time like this, Directors need to be extra vigilant and regularly revisit their cash flow projections and assumptions.

If matters are critical then accurate financial information is essential and regular reviews are necessary with to compare actual vs forecasts which will reveal any adverse trends and allow you to take early remedial action where possible.

Under the Insolvency Act 1986, section 123(1)(e), a company is deemed to be unable to pay its debts if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

Test 2: Balance sheet

Reference to the balance sheet will reveal if your **liabilities exceed your assets** and if so, then you can conclude that your company is insolvent. Simply put, there are insufficient assets to cover payment in full of all liabilities. Share capital should not be included for the purposes of this calculation.

It is often the case that it can be many months after year end before the accounts are signed off and an accurate assessment can be made. However, in reality, today's cloud-based software packages can determine the true position very quickly, sufficient to give cause for concern and allow the directors to act upon it.

If a business fails either of the above tests, then it is considered to be insolvent.

It is the responsibility of all directors to understand the company's financial position, and be alert to cash flow difficulties and all other material trading issues. Directors can be made personally liability for the company's debts, if their actions amount to a deterioration in the creditor's position. Directors can also face up to 15 years disqualification at the hands of the Insolvency Service (based on the level and severity of the actions).

Under the Insolvency Act 1986, section 123(2), a company is also deemed to be unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

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- Business Advisory
- Corporate Finance
- Forensic Accounting
- Equity

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Disclaimer

This article sets out some of the more common questions raised by Directors in such circumstances. It is not intended to be exhaustive or comprehensive guide to Insolvency legislation or the law relating to it. Directors are strongly advised to seek independent legal advice and speak to an Insolvency Practitioner.

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