

Trouble at the Boardroom

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Editor's Note: Whatever the jurisdiction, a troubled corporate will always need its lawyers. Often the issue closest to an officer's heart in a pre-bankruptcy situation is whether he could become personally responsible for the business' demise. Navigating the duties owed to the corporate will often be a staple part of the debtor's lawyer's remit.

In our February European Update, we wrote about the impact for the restructuring and insolvency market of the Companies Act 2006. On Oct. 1, 2007, that statute brought into effect a codification of the duties owed by directors of U.K. corporates. In this month's article, Ken Baird highlights the challenges likely to be faced by bankruptcy lawyers, as a result of the changes, when advising the directors of distressed companies.

Another aspect of the Companies Act that will be keenly followed is the ability of a shareholder to bring a derivative action. The legislation makes changes so that the range of circumstances in which a derivative action may now be brought is wider than under the former common law (as set out by the rule in *Foss v Harbottle*).

A derivative claim may be brought in respect of an alleged breach of any of the general duties of directors set out in the Companies Act. The changes mean that there is no longer a requirement for personal gain by the director in order for a derivative action to be brought (as was the case under the former common law).

The new derivative procedure is not akin to U.S.-style class actions particularly as any damages awarded as a result of a derivative claim go to the company, not the shareholder. Even if only used as a threat to leverage settlement, it will be interesting to see how quickly shareholder activists latch onto this new weapon in their armory.

Lawyers hate Companies Acts. Just as they get to know all the section numbers for the Act that they study at university, somebody comes along and changes them all—never more so than with the latest incarnation entitled The Companies Act 2006. You may (or may not) be interested to know that the bill

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was originally entitled The Company Law (Reform) Bill 2006, but after much discussion it was decided that they would save a few precious words by simply calling it The Companies Act 2006. It is a pity the same could not have been said for the substance of the Act itself. Comprising some 1,300 sections and 16 schedules in all, it is reportedly the single biggest piece of legislation ever to face the two Houses of Parliament. Good luck to the European Union as it tries to enact the concept of “legal personality.”

European Update



Adam Gallagher

Returning to the theme, however, the Companies Act has lots of implications for lots of different constituencies. In the public company field the Act constitutes an attempt to haul company law kicking and screaming straight from the 19th century into the 21st century without stopping to pass go or to collect \$200. The net effect is a whole new raft of rules permitting electronic communication with shareholders, etc. There will be many sleepless nights for in-house general counsel worrying (in the alternate) between getting to grips with new law or having to pay city lawyers to explain the differences!

Equally, there is an attempt to remove so called “red tape” surrounding private companies. It does seem to be a trend of modern government that with one hand it purports to hack through and take away red tape but with the other hand it wraps ever stronger and tighter coils of it around small businesses. The same is true of the proposed reform. It is difficult to believe that the changes will not result in small businesses having even more to do than ever simply to keep up with the bureaucratic constraints on them.

Directors' Duties: Codification



Ken Baird

The government decided it was time to codify some, but not all, of the duties directors should concern themselves with. Codification is a dangerous game. The government tried it once before with the Theft Act 1968, believing that a codified law would cure the evils of the common law or “judge-made law,” which created endless loopholes. Sadly, it did not work. Police officers, when confronted with people driving away from gas stations with unpaid-for gas, were left scratching their heads. No provision of the Theft Act seemed to cover this in the face of the

hapless thief's assertions that they were merely “borrowing” the gas. To be honest, the law of theft has never recovered.

So codification should be approached with a suitable degree of trepidation. In any event, the Act contains in §§170 to 177 the following key duties of directors (some of which will be familiar):

- a duty to act in accordance with the company's constitution and to use powers only for the purposes for which they were conferred.
- a duty to promote the success of the company for the benefit of its members and in doing so *have regard to a list of particular matters* (we'll come back to this one later).
- a duty to exercise independent judgment.
- a duty to exercise reasonable care, skill and diligence.¹
- a duty to avoid conflicts of interest.
- a duty not to accept benefits from third parties.
- a duty to declare to the company's other directors any interest a director has in a proposed transaction or arrangement with the company.

Now, as practitioners of the noble art of insolvency, a lot of the above will be of limited interest to you. By this I mean

¹ It is beyond the scope of this article, but it is interesting to note that the statutory duty here is framed in the same language as the standards against which a director will be judged in relation to s214 of the Insolvency Act 1986 (wrongful trading).

that once we get interested in the company, the niceties of how directors discharge their duties seem somewhat far down the agenda. However, those familiar with the English common law will immediately notice one major change. This is the creation of the so called “have regard to” matters. Just like any good fairy tale, there are seven of these, and these are:

- the likely long-term consequences of their decisions;
- the interests of the company’s employees;
- the need to foster the company’s business relationships with suppliers, customers and others;
- the impact of the company’s operations on the community and the environment;
- the desirability of maintaining a reputation for high standards of business conduct;
- the need to act fairly as between members of the company; and
- in effect, anything else of relevance.

You will notice I have had to cheat a little bit to make the dwarf analogy work by inserting a seventh, being “anything else you fancy.” However, since the list of “have regards to” is not exhaustive,

then—wearing a lawyer’s hat—there must be a seventh which is “anything else.” Now the dwarf analogy is perfect.

Returning again to our theme, “have regards to” is a very important phrase for lawyers when it comes to worrying about insolvent companies. This is because for many years lawyers practicing the dark art of insolvency have had to worry about the question of when the directors should be “having regard to” the interest of the company’s shareholders or “its creditors.” The test here tends to be a bit like trying to describe an elephant—difficult to do in words, but you will know it when you see it! Another analogy that comes in handy is with the Geoff Boycott-inspired phrase “the zone of insolvency” (apologies for those American readers not familiar with great English cricketers). The zone of insolvency opens up as it becomes apparent that there may not be sufficient value in the business to leave a surplus for shareholders once creditors are paid. As one moves into this zone, the need to look after the interests of creditors first becomes increasingly high, and then paramount once it is clear that shareholders are out of the money. The case law on this is reasonably clear (*West Mercia Safetywear Ltd. (liquidation of) v*

*Dodd*²) on the modern remedy of wrongful trading, and §214 of the Insolvency Act 1986 effectively gives recognition to this text.

Now, returning to the new Companies Act, does the codification extend to dealing with companies in trouble? The answer is “no,” but we are given some guidance by the following provision in §172(3):

[T]he duty imposed by this section [to promote the success of the company for the benefit of its members as a whole] has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

So, this is crystal clear! Nothing in this new law is to affect any of the existing common law issues as they affect advising the directors of companies in trouble. That’s good news. That means that we can carry on simply having regard to interests of shareholders and creditors depending upon how much value there is

² [1988] BCLC 250.

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in the business concerns. But hang on a second: What about the seven dwarfs? What about the seven other “have regard to” matters that the pesky directors might decide now interfere with the insolvency lawyer’s simple “ugly sisters” (sister one being shareholders and sister two being creditors)? Let me give some examples.

Example One: The French Croissant Co.

The French Croissant Co. owns croissant booths at both the English and French ends of the Eurotunnel. The French Croissant Co. has one director entitled Monsieur Le Patisserie. The company gets into financial difficulties. In advising him, it is clear that he should be “having regard to” his creditors rather than his shareholders since the croissant business is plainly bust: None of his English customers are buying croissants, and French people tend not to use the Eurostar. The problem is that the company has a number of employees both in England and France who he wishes to protect. The conversation goes like this:

Lawyer: “Monsieur Le Patisserie, it is essential that you ‘have regard to’ the company’s creditors and stop trading. You are trading at a hopeless loss week in and week out and simply worsening the recovery.”

Monsieur Le Patisserie: “But you do not understand...my main duty is to ‘ave regard to zee interest of my employees. I cannot possibly shut down zees business. Doesn’t zee new Companies Act makes it clear?”

Here is another example where other dwarfs will bump into the ugly sisters.

Example Two: Go Green Ltd.

Go Green Ltd. is a waste collection company specializing in collecting recyclable rubbish and turning it into children’s toys, fashion items and furniture. One of its key contracts is with the local council of Wedgefield. However, it faces stiff competition from Burn It or Dump It Ltd. owned by a Mr. Brown—an old-fashioned outfit not interested in green matters but whose services are considerably cheaper than those offered by Go Green Ltd. As a result of a recent

scandal involving several members of the local council who claimed to be measuring the height of the curb when caught crawling along it, power in the local council has shifted to Mr Brown’s brother. He awards the council collection of rubbish to his brother’s business, much to the consternation of the electorate and Go Green Ltd. who, in spite of rising debts, refuses to file for insolvency.

In a spirited campaign to have Go Green Ltd. reinstated as the council’s rubbish collector, the local community organizes a press conference to bring awareness of the issue to the public at wide. When interviewed, the Managing Director of Go Green Ltd. says: “We can’t let our people down; our employees are all local, our services are good for the environment and our recycled goods are sold to the local children’s playgroup. We won’t go down—there’s too much at stake, including our reputation.”

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And therein lies the difficulty. Lawyers will have a great deal more to do to make it clear that the “have regard to” matters mentioned in the Companies Act must not be allowed to distract directors from doing the right thing when the company’s solvency is in question.

The biggest problem I foresee comes down to the question of identifying when the “zone of uncertainty” begins. The main problem being that if a company is not in this zone, it becomes much easier for a director to say that he must “have regard to” things that are contained in §172. As any practitioner in this area knows, it is extremely difficult to identify exactly when the value of a business starts to break below the level needed to pay creditors in full. Even in trying to reach a judgment on value,

there are a host of competing issues, including:

1. The distressed/forced sale value of assets will be very low.
2. The “enterprise valuation” would be very high but very subjective.
3. There may be a dozen valuations of somewhere in between.

However, as a matter of navigating one’s way through the new Companies Act, as it impacts on advising distressed companies, it will be critical to identify when the zone of uncertainty begins precisely to avoid having the argument about the relevance of the “have regard to” matters. In summary:

1. There will be even more need to be vigorous about documenting the point of which there is genuine concern about inability to meet creditors in full.
2. Lawyers must be robust in advising that many “have regard to” factors that may have influenced conduct outside of insolvency may simply now not be relevant.
3. The more of this that is written into the minutes—and the earlier—the better.

Conclusion

The Companies Act may be many things to many people. However, for advisers in insolvency law it has opened up a can of worms that is unwelcome. Most advisers were pretty confident about when the duty of directors switched from protecting the interests of shareholders to those of creditors—even though the law may not have been articulated in detail. I predict that new law may result in situations where (1) some companies that should have gone into a protective procedure sooner will be delayed due to excessive deference to the “have regard to” matters, and (2) well-advised companies with genuine competing issues to take account of may find it more difficult to make a decision seeking a protective procedure because of nervousness about the “have regard to” matters.

I am not sure any of the above is welcomed news for directors or their financial advisors, but I suspect none of it will do the lawyers any harm. ■