

FortyTwo Talks:
Directors in Trouble: Personal Liability
Paul Fuller & Lucas Nacif

Lucas Nacif: Hello, and welcome to *FortyTwo Talks*. This is the fourth episode of our latest mini-series on Insolvency Law, and for today's episode, we will discuss the topic titled '*Directors in Trouble: Personal Liability*'.

This podcast explores the circumstances where a director moves from the relative safety of limited liability into becoming personally liable in an insolvency context.

We're going to explore topics such as personal guarantees, misfeasance, wrongful trading, transactions at undervalue, preferences, as well as director disqualification.

My name is Lucas Nacif, a barrister at 42BR that specialises in Employment, Commercial, and Insolvency Litigation.

Paul Fuller: And my name's Paul Fuller, also a barrister at 42BR with a predominantly Business, Property, and Chancery practice.

Lucas Nacif: So, we would like to begin by reminding our audience of the basics.

Many companies are limited by shares, meaning that its shareholders are only liable up to the nominal amount of the shares in the event a company goes into liquidation.

A shareholder is not liable for anything over above that amount, meaning that a shareholder, generally speaking, is not liable to pay the debts of a company or the cost of the liquidation.

And this is particularly crucial for closely held companies where the shareholders are also the directors of the company.

Paul Fuller: Of course, limited liability only benefits the members or shareholders of a company with statutory directors, the starting point is the director is bound by strict duties, which are codified by sections 170–177 of the Companies Act 2006, and which are owed to the company.

So generally speaking, whilst a company remains solvent, the only persons with standing to sue a director is either the company itself or a shareholder that brings a derivative claim or potentially a claim for unfair prejudice.

Directors are not generally personally liable to third parties. When a company goes into liquidation however, the director loses their powers to control the company's affairs or conduct the acts of the company, and similarly, in administration a director cannot exercise any management power without the consent of the administrator. And significantly, in company insolvency, a director can also become personally liable for their actions and even become disqualified to act as a director as a result of those actions.

So, we're going to look at the various provisions of the Insolvency Act 1986 and the Company Directors Disqualification Act 1986, under which directors and others can be disqualified from office or subjected to personal liability for the debts of their companies or the actions that they carry out whilst in office.

Lucas Nacif: Now, before we go into detail about the Insolvency Act and Directors Disqualifications, we just want to briefly talk about personal guarantees.

So, director of a company, generally speaking, is not personally liable for the debts of the company as we just discussed. However, if a director has given guarantee for the liabilities of the company, the director may be personally liable under the guarantee.

For example, the director might agree to pay a sum due or indemnify a creditor if the company fails to pay its debts.

There are various reasons why a director would agree to a guarantee, for example, a company with limited trading history or poor credit rating may need a personal guarantee to access finance.

After all, a lender might be hesitant to lend money to a small company with limited assets given the concept of limited liability.

Paul Fuller: What of wrongful trading then?

Well, Section 214 of the Insolvency Act enables a liquidator to make an application which, if successful, would render the director liable to make such contribution to the company's assets as the court thinks proper.

For a person to be made liable for wrongful trading, there are three requirements:

First, the company has to go into insolvent liquidation.

At some point for the commencement of that insolvent liquidation process, the person who is potentially liable must have known or to have concluded that there was no reasonable prospect that the company would avoid going into liquidation or entering into insolvent administration.

And lastly, the person must be a director at that time.

Lucas Nacif: There's some important things to bear in mind about wrongful trading.

The first is that Section 214 was introduced to stop directors from continuing to trade while their companies are sliding into insolvency, and it's to allow the liquidator to recoup the losses to the company caused by the actions of the directors.

It's intended to benefit the creditors as a whole, however, it's been made clear that liability is only imposed where the directors knew or ought to have concluded that the company could not avoid entering into insolvent liquidation, and an example of this is in the case of *Re Hawkes Hill Publishing Company Ltd in Liquidation* 2007 BPIR 1305.

Paul Fuller: The courts don't readily impose liability on directors, and this is particularly the case where the directors can show that their actions have been carried out after obtaining appropriate professional advice. In most cases, where directors have been found liable, they've been found to have acted irresponsibly.

Importantly, the courts don't tend to place a great deal of emphasis on hindsight.

Lucas Nacif: In determining whether a director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation where a company is cashflow or balance sheet insolvent, the usual question for the court is to ask whether the directors honestly and reasonably believed that there was a prospect that they could trade themselves out of insolvency and, given time, avoid liquidation or administration altogether.

According to the High Court in the case of *Wright v Chappell* 2024 EWHC 1417 of the Chancery Division, the critical question is whether there was light at the end of the tunnel. Directors are not liable for wrongful

trading because the company was insolvent, but only if they either knew or ought to have known that insolvent liquidation or administration could not have been avoided and was now inevitable.

Crucially, the court must be satisfied that the prospect of trading out of insolvency was more than a fanciful or reasonable one. The authorities, for example, emphasise that a director's belief must be a rational one and that blind optimism is not sufficient to defeat liability under Section 214.

Paul Fuller: Now, when assessing whether a director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation, the courts aren't limited to taking into account the material available to the director during the time when the wrongful trading is alleged to have occurred.

The court can also refer to material that was available to be accessed by a person exercising reasonable diligence and an appropriate level of general knowledge.

So, for example, where a director performs a specialist function, such as a finance director, the court can take into account the special skills expected of a person discharging the duties of a finance director.

The courts can also take into account the kind of company, managed by the director, as well as the type of business involved.

Lucas Nacif: Under Section 214, it's a defence for a director to establish that he or she took every step with a view to minimising creditor's losses. The phrase 'every step' is not defined, and one cannot really ascertain what it's meant by the phrase from the surrounding provisions.

It's difficult for a director to know what every step is, and when he or she has completed taking all the steps necessary, the extreme

measure of entering liquidation cannot be taken by a single director, when you have multiple directors in the board. So, a concerned director has to convince a majority of the board that liquidation is the appropriate avenue to go down.

In *Re Continental Assurance*, Mr Justice Park was impressed by the fact that the directors reduced the scale of trading to minimal and cautious levels and eventually ceased trading when they were advised that the company was insolvent.

In contrast, in the case of *Re Adessa UK Ltd* from 2011, the directors failed in their defence as they have not tightened the corporate belt or encouraged cost savings or indeed done anything differently despite the company's financial state.

Paul Fuller: To bring a successful action in practice, a liquidator or an administrator will likely need to undertake a significant amount of work and probably incur substantial expense doing so.

For example, a liquidator or administrator will need to produce evidence not only of the director's wrongful trading or dealings, but also the wrongful dealings that those wrongful dealings resulted in loss to the creditors, that they would not otherwise have suffered.

It's also worth noting that becoming liable for wrongful dealings may result in the director becoming disqualified, something which we'll address in greater detail, in a moment.

Lucas Nacif: So, Paul, let's now talk about the misfeasance provision, shall we?

Paul Fuller: Sure.

So, Section 212 of the 1986 Act provides a summary remedy against errant directors who are guilty of any misfeasance or breach of fiduciary duty or other duty in relation to the company.

If successful, the court can compel the director to repay, restore, or account for the money or property or any part of it received, or contribute such sums to the company's assets by way of compensation in respect to the misfeasance or breach of fiduciary duty or other duty as the court thinks just.

Lucas Nacif: As made clear from Paul's explanation, misfeasance covers the whole spectrum of duties of directors, and it's not restricted to cases where the director is guilty of moral turpitude.

The term misfeasance is broad, and it can cover a wide range of duties. Section 212 could, for example, be used to bring proceedings against a director who's negligent, as well as a director that makes a secret profit, grants preferences to creditors, or commits some other breach of fiduciary duty.

Paul Fuller: A claim under Section 212 may be brought by the liquidator or any creditor or contributory of the company.

It's important to note, however, that if a creditor makes an application under Section 212, the order can only be made to the benefit of the company and not the applicant. So, what this means is that any recovery from a claim brought under Section 212 will form part of the assets of the insolvent estate, and any creditor or contributory who brings a claim under Section 212 must pay any compensation recovered to the liquidator or administrator for those purposes.

However, the administrator or liquidator may agree to the applicant retaining a proportion of the recovery made in consideration of the creditor bearing the litigation risk.

Lucas Nacif: It's important, reminding ourselves, also that a director who's found liable under Section 212 may also be liable under other provisions of the Insolvency Act, including wrongful trading and preferences under Section 239.

So, in other words, it's simply not the case that liability under Section 212 is mutually exclusive from other provisions like wrongful trading in Section 214.

We're now going to speak about transactions at an undervalue. Over to you, Paul.

Paul Fuller: Sure.

So, Section 238 of the Insolvency Act governs this provision and applies to companies that go into liquidation or administration.

The liquidator or administrator can make an application under Section 238, which enables the court to make an order restoring the position that it would have been had the company not entered into the transaction at an undervalue.

The justification for setting aside a disposition of assets made shortly before the onset of insolvency is that by depleting the estate, the disposition unfairly prejudices the creditors as a whole, and even where the disposition is in satisfaction of say, a debt lawfully owing by the insolvent's company, by altering the distribution of the estate, it makes a pari passu distribution amongst all of the unsecured creditors impossible.

If we look at Section 238, a company enters into a transaction at an undervalue if the company makes a gift to a person or otherwise enters into a transaction with persons on terms that provide for the company to receive no consideration, or the company enters into a transaction with a person for a consideration, the value of which in

money or money's worth is significantly less than the value in money or money's worth of the consideration provided by the company.

Lucas Nacif: The transaction in question must have occurred during the relevant time, which involves two aspects:

First, the transaction must have occurred in a particular time zone, namely the two years preceding the onset of insolvency.

An onset of insolvency is defined in subsection three of Section 240.

Secondly, besides following within this time zone, the transaction must have been entered into at the time when the company was unable to pay its debts within the meaning of Section 123 of the Insolvency Act, or the entry into the transaction resulted in the company being unable to pay its debts.

The latter requirement is not relevant where the transaction was entered into with a person connected with a company, which is defined in Section 240(2), although in such a case, the two year time period still applies.

As far as valuation goes, it's been said that the question in every case would be whether there's a significant disparity in the consideration moving from and to the debtor, and an example of this can be illustrated in *Ramlort v Reid* 2004 BPIR 985, particularly paragraphs 102-105 of the judgment.

It's worth noting that there is a defence under Section 238. If a company which entered into the transaction at an undervalue did so in good faith and for the purpose for carrying on its business, and there were reasonable grounds at the time of entering into the transaction that would benefit the company.

Paul Fuller: The defence is rarely successful, and indeed in *TAQA Bratani Ltd v Fujairah Oil 2025* that's a neutral citation, EWCA Civ 1669 case, Lady Justice Falk said at paragraph 57 that it's difficult to see how taken in isolation a transaction at an undervalue could ever reasonably be believed to be to the benefit of an insolvent company.

Lucas Nacif: We're now going to talk about preferences, which is governed by Section 239 of the Insolvency Act.

This deals with situations where the company has, at the relevant time, given a preference to any person which is a creditor, surety, or guarantor, and results in the creditor being in a better position than other creditors in the insolvent liquidation.

To summarise, these are transactions that involve a creditor getting paid more than would be paid to other creditors in the winding up.

If such transaction could not be adjusted, then creditors would just grab what they could as quickly as possible when there's an inkling that the company is heading towards insolvency, and this would affect the statutorily regulated system laid down for the payment of creditors in an insolvency.

So, Paul, can you give me some examples of preferences?

Paul Fuller: Yes, of course. An example might be where a company grants security to a previously unsecured creditor. That could be a preference if the necessary desire to prefer is present, an example where that was the case is the case of *Re Mistral Finance Ltd 2001*, neutral citation BCC 27.

Another example could be paying an unsecured debt owed to one creditor where there are other debts owed to others not being paid, that may where, again, be a preference where the requisite desire is present.

However, payment to crucial suppliers to ensure future supplies and payments to employees may be commercially justified in order to keep the company trading if, for example, a rescue transaction is in reasonable prospect, the circumstances might mean that there is no desire in those cases to prefer.

So having gone through the provisions of the Insolvency Act, we're now going to talk about director disqualification.

Director disqualification is a process where an individual is banned from being a company director for up to fifteen years. It's meant to protect the public against the activities of errant directors who abuse the privileges of corporate personality and limited liability.

Only the Secretary of State or the official receiver on the direction of the Secretary of State can apply a disqualification under Section 6 of the Company Directors Disqualification Act of 1986. However, Section 7(3) requires liquidators or other office holders, including administrative receivers, to report the conduct or any conduct that would, in their view, appear to satisfy Section 6 of the Act.

So, Lucas, can you give us some examples of grounds for disqualification?

Lucas Nacif: Absolutely.

It includes fraud, being unfit, and being liable for wrongful trading, which we discussed at the start of the podcast.

Paul Fuller: Meaning?

Lucas Nacif: Well, with unfitness, the unfitness ground is set out in Section 6 of the Company Directors Disqualification Act, it states that a court shall make a disqualification order against a person in any case where on application it is satisfied that two grounds are met.

The first ground is that the person is or has been a director of a company which has at any time become insolvent, whether while the person was a director or subsequently, or that the person has been a director of a company which has at any time been dissolved without becoming insolvent.

The second ground is that the court is satisfied that the person's conduct has a director of the company, either taken alone or together with a person's conduct as a director of one or more companies, or indeed overseas companies, makes the person unfit to be concerned in the management of a company.

Unfitness requires conduct in breach of the standards of commercial morality or some gross incompetence, such as to convince the court that it would be a danger to the public to allow that person to continue to be involved in the management of companies.

Now, in determining unfitness, the court must take into account the matters listed at Schedule 1 of the Disqualification Act, and the factors include, but are not limited to, the extent to which a person was responsible for the causes of a company becoming insolvent, the nature and extent of any loss or harm caused, or any potential loss or harm which could have been caused, by the person's conduct, and indeed any misfeasance or breach of fiduciary duties by the director in question.

So, Paul, can you give me some examples of directors being found to be unfit?

Paul Fuller: Well yes, for sure.

One example might be where the directors have used PAYE, national insurance or VAT payments to finance the company's trading activities, and that director knew or ought to have known what was

happening, that conduct was held to be improper, for example, the case of *Re Cladrose Ltd*. That's a 1990, neutral citation BCLC 204.

Another example, could be a failure to comply with the obligation to file company audited accounts or an annual return, even if that failure was due to work pressures, and again, a case where that was held to be the case is *Re Churchill Hotel (Plymouth) Ltd* a 1988 case, neutral citation BCLC 341.

Similarly, in *Secretary of State for Trade and Industry v Blunt* 2005, neutral citation 2 BCLC 463, the defendant director of a company insolvency liquidation had removed a substantial amount of stock and attempted to conceal its whereabouts from the liquidator.

On the basis he eventually admitted the charges brought, the court disqualified him for six years.

Lucas, can you think of any other examples?

Lucas Nacif: Absolutely.

So, in the case of *Secretary of State for Business and Enterprise v Coulson*, also known as *Re Artistic Investment Advisers Ltd*, neutral citation 2014 EWHC 2963 CH, the cumulative effect of a director's misconduct was held to be capable of amounting to unfitness.

In that case, the conduct in question comprised of a failure to keep adequate accounting records and a failure to deliver those records to the liquidator.

In *Re Avocad Ltd*, neutral citation 2021 EWHC 1501 CH, the court disqualified directors under Section 6, which is unfitness, for causing the company to enter into a number of transactions and to make payment to themselves in relation to outstanding loans to the

company in circumstances where they knew or should have known that the company was insolvent on a balance sheet basis.

The director's conduct had fallen substantially short of the required standards of probity and competence. The position of the company's creditors in that case, including the HMRC as a contingent director, was substantially prejudiced due to the director's conduct.

Now, is there any guidance, Paul, on how long a director should be disqualified?

Paul Fuller: Yes, the Court of Appeal in *Re Sevenoaks Stationers Retail Ltd 1991*, neutral citation Chancery 164, set out three brackets for disqualification periods:

- The top bracket of disqualification of over ten years, the court said should be preserved for particularly severe cases. For instance, where the person falls to be disqualified for a second time.
- A middle bracket of six to ten years, the court said should apply in serious cases that don't make that top bracket.
- And a minimum bracket of two to five years should apply to serious cases that don't take either of the middle or top brackets.

Also worth noting that the time for the Secretary of State or the official receiver to make an application under Section 6 is three years from the date on which the company becomes insolvent.

And although the court may grant the Secretary of State permission to make an application out of time when taking into account factors such as the seriousness of misconduct or the merits of the application and the reasons for the delay, the time limits should be borne in mind.

So, now we discuss ways in which a director can be made personally liable, what can directors do to limit their exposure?

Lucas Nacif: I'd say that a well advised director should look into obtaining a D&O insurance. That provides personal protection to individual directors and officers of a company, for example, subject to the terms and conditions of the policy it is possible that the D&O policy can provide cover for the defence costs and adverse judgment against a director.

Paul Fuller: Although, of course in practice, Directors & Officers Policies often exclude claims where the insured has committed misconduct or acted fraudulently or dishonestly. Some policies will, however, provide defence costs to the insured until fraud or dishonesty is proven in final judgment or by admission.

Of course, it also goes without saying that obtaining a Directors & Officers Policy can be expensive and might be out of reach for some directors.

Lucas Nacif: I think it's fair to say then that if you decide to become a company director, you need to accept that there will be risks involved, but if you're prudent and cautious, and you act on professional advice when making difficult business decisions, particularly when your company's facing financial distress, you are likely to avoid being criticized by a judge in the near future.

Paul Fuller: Well, I think that just about wraps us up here today, so thank you again for tuning in to *FortyTwo Talks*. We hope you've enjoyed the podcast.

If you'd like advice on directors' duties and liabilities, then please do get in touch with us at 42BR Barristers.

The next episode in this series will be coming out in a week or two, where we'll be discussing undoing orders, annulments, and rescission with our colleagues here, Michael Grant and Christopher McCarthy.

To listen to other episodes, follow us on Spotify, Apple Podcasts, or wherever else you get your podcasts.

Otherwise, thanks again for joining us today.

Lucas Nacif: Thank you, and goodbye.

Paul Fuller: Goodbye.