Corporate restructuring guidelines

Corporate governance

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1. Introduction

Corporate governance considerations are important for all companies but for companies who are restructuring there may be particular issues and concerns. In a downturn many companies face collapsing order books, rising costs and excess capacity. Good governance will help identify these trends early enough to be able to better manage and cope with them. Lack of governance will typically exacerbate the situation and accelerate a company’s freefall.

Corporate governance codes in Ireland are largely self-regulating and UK based. In addition, we also have a body of Company Law which regulate how companies should be structured, governed and managed. Supporting these legal and voluntary rules are a number of regulatory agencies each charged with particular enforcement powers. These agencies include the Companies Registration Office, the Irish Stock Exchange, the Office of the Director of Corporate Enforcement, the Irish Auditing and Accounting Supervisory, the Competition Authority, and the sectoral regulators. Each of these state agencies has an interest in enforcing corporate governance standards.

On the broader global stage, the European Commission also sets standards for corporate governance as does the OECD, and the IMF. The National Standards Authority in conjunction with the Institute for Directors are currently working with regulators and business representatives (including IBEC) to further develop and encourage Irish corporate governance standards.

Ireland’s ranking as an economy with a well-developed corporate governance culture is fairly good. There are, however, some chinks to it. The World Bank ranks countries for ease of doing business. Of the 181 economies ranked each year, Ireland ranks 7th in 2009 for ease of doing business, a ranking held last year also. An important rank in terms of corporate governance is the ranking which we have on protection of investors. We are 5th out of 181 countries and have held that ranking from 2008 through to 2009. That overall ranking is divided into four and we do well on the transparency of transactions index and on the shareholders ability to sue for misconduct. We do less well, although still somewhat higher than the average OECD ranking, on the directors’ liability index which measures the liability of company officers for self-dealing.

Corporate governance is managed here in a number of ways:

- The Stock Exchange impose corporate governance requirements on listed companies – the so-called listing rules that attach the UK’s Combined Code which sets out the principles of corporate governance for publicly-quoted companies. Companies are required to comply with the Combined Code or provide a publicly available explanation for their non-compliance. The Combined Code gives guidance in a number of key areas, such as the appointment of non-executive directors, the composition of the board and sub-committees, the establishment of an audit committee, the appointment of external auditors, communications with shareholders, internal risk management controls, the use of nomination and remuneration committees, the roles of chairman and CEO. However, it is a principles-based system, which relies on the judgement of company directors and as such does not require in-depth disclosure, instead operating largely on a comply or explain basis.

The Combined Code1 does not form part of the Stock Exchanges listing rules rather it is an add-on to them. So while companies listed on the Stock Exchange are not required to

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CORPORATE GOVERNANCE

comply with the provisions of the Combined Code, if they fail to do so they must disclose that fact and explain why not. Less than 50% of the FTSE 100 companies in the UK state that they are fully compliant with the Revised Combined Code in its entirety. However, most companies would comply with a major part of it.

It is important to point out that private companies do not have to comply with the Combined Code. However, it is the template for many and is seen as best practice.

- Company law is becoming increasingly more important in the area of corporate governance. Ireland’s original mainframe Company Law Act of 1963 was based on its UK counterpart of 1948 and it has been extensively revised since the 1980s. It is currently the subject of a major revision which will come to fruition with a new Companies Bill next year. Since 1996, there has been an ongoing review of company law to ensure that Irish company law is modern and up-to-date. This has resulted in wide sweeping changes and in recent years, in particular, to significant improvements in compliance and enforcement.

- Improving compliance standards for businesses is important in order to encourage inward direct investment and to ensure foreign investors that the Irish ran a tight ship. The Office of the Director of Corporate Enforcement was set up with a view to ensuring stricter enforcement of company law and is now armed with a plethora of significant powers to tackle rogue directors and bad practices. The Office was set up prior to Enron and other global corporate governance scandals. However, by then we had had our own corporate scandals and were in a position to react decisively by establishing the new corporate policeman.

- The Companies (Auditing and Accounting) Act 2003 set up new standards of accounting oversight here. It established a new regulator for auditors and accountants - the Irish Auditing and Accounting Supervisory Authority (IAASA), and it introduced into law the concept of an audit committee. While the audit committee was a feature of the Combined Code, this was the first time it was written into Irish law. Nevertheless, even though not strictly required by law just yet, it is good practice for large private companies and public companies to have an audit committee in place. Under the Combined Code, listed companies who do not have audit committees must explain why they do not.

- The Criminal Law (Theft and Fraud Offences) Act of 2001 is an Act which deals with corporate fraud. It imposes whistleblowing obligations on auditors where they believe there is fraud being perpetrated within a company. Whistleblowing obligations are also incorporated in the Companies (Auditing and Accounting) Act of 2003 obliging liquidators also to whistleblow in the event that they discover corporate wrongdoing.

- The Companies (Auditing and Accounting) Act of 2003 also introduced the concept of a Directors’ Compliance Statement. This is not yet law here. The obligation, when commenced, is limited to public companies and only those private companies with a balance sheet total of more than £7.5 million and a turnover of over £15 million. The directors will be obliged to prepare a statement which certifies that they are compliant with their legal obligations under tax law, company law and any other relevant law within which the company operates and which materially affects its financial statements. The auditor in turn must opine on whether the compliance statement is fair and reasonable. The compliance statement was shelved after review by the Company Law Review Group in 2005, however is expected to be resurrected, in the above format, under the forthcoming new Companies Bill.
2. **Board structure and governance**

The board is responsible for directing and stewarding the company. It does this by making sure that the business is planned, its risks managed, and proper governance arrangements are in place. The board effectively leads and in doing so it decides a strategy and regulates how the executive carry out that strategy. It does this largely through the board’s sub-committees of the audit, remuneration and nomination committees which are prevalent in larger companies in particular. For smaller companies it may not be appropriate to have all three but there should, where possible, be at least an audit committee.

**Role of the CEO and Chairman**

The role of the Chairman and CEO are mutually exclusive this side of the Atlantic, however, it is commonplace in the US for the same individual to occupy both posts. The recommended split in the roles happened in the early 1990s by the Cadbury Report on Corporate Governance in the UK. It is and remains, however, a recommendation rather than a requirement. However, most listed companies ensure separation thus differentiating leadership of the board from the operational running of the business.

It is good practice to set out the duties and responsibilities of both posts. It is for the same reason that the former CEO should not assume the chairmanship of a company. Again, while this is a recommendation, it is not obligatory. However, the majority of larger listed companies adhere to it. This ensures clear lines of authority without overlap.

**Board committees**

Common board committees are the audit, remuneration and nomination committees typical in Public Listed Companies. It is not usual for the Chairman of the company to chair any of its sub-committees. However, the Chairman can be a member of a board sub-committee despite the fact that in practice most aren’t.

The audit committee is particularly important in troubled times. Pressure from investors can often lead a business into risky actions that may not be in the best long-term interest of the company although it may deliver a short-term benefit and the audit committee can act as an important analyst to the Board.

The audit committee is the committee that reviews and monitors the systems of internal control within a company generally. Some of the larger companies may have their own risk committees, however, usually it is the audit committee who reviews how the company manages risk. Most audit committees will have a financial expert and for most companies that will be a member of the board with the financial expertise and background. That person will often assume the role of chairman. The committee is generally serviced by the company’s executive financial manager.

The audit committee will report to the board on what they see as the failings and weaknesses of the company’s internal control mechanisms. They may bring in external assistance to help them identify those weaknesses or failings and they will generally bring to the board recommendations for improvement.

The other main committee, particularly for large companies, is the remuneration committee. Balancing remuneration and performance can be tricky and is often sector led. The remuneration
CORPORATE GOVERNANCE

A remuneration committee will generally deal with the setting of remuneration, the bonus conditions and performance criteria. Having a remuneration committee is important for larger companies in particular, as it causes the board to think through what remuneration policy is appropriate for their company at that point in time. The remuneration committee generally deals only with the remuneration of the CEO and board members. However, the culture set by the remuneration committee will invariably set the remuneration culture of the business.

Public disclosures for limited companies

Disclosure of the remuneration of individual directors in Irish quoted companies was introduced in 2001. In addition the Combined Code requires companies to state in the annual report what their remuneration policy is. More recently the European Commission has adopted a Recommendation asking member states that they ensure that listed companies have appropriate remuneration policies and to indicate progress to the Commission by the end of 2009. The Recommendation gives guidelines on what they should be using effectively the ‘comply or explain’ model already in use through the Combined Code.

Since 2007 all Irish-registered limited liability companies must display certain information on their letterhead and all documents which they communicate with such as their e-mail, their fax, their website, their order forms, invoices etc. Prior to this there was a standing requirement under Company Law that a company would display its registered office, its registered number and its directors on their letterheads. Since 1st April 2007 those requirements are now extended to cover websites and electronic communications of the company. On those documents should appear the full name of the company, its registered office, its registered number, and the names of each of its directors (and their nationality, if not Irish).

If a company is being wound-up then the communications, be they electronic or hard copy, should state the fact that the company is being wound up. The company should also state what its legal status is, that is usually that it is a limited company. For those companies who have an exemption from using the word “limited” they must identify themselves in their documentation.

In addition, limited companies must file with the Companies Registration Office a variety of other information which will be publicly available. The names and residential addresses and other directorships of each director must be supplied (new law is expected shortly which will allow for the suppression of residential addresses of directors in certain circumstances). Where changes occur, these must be notified but in any event, the information is resupplied annually. Also, unless the company is audit exempt, it must file annual accounts which include a profit and loss account and a balance sheet. The Auditor’s Report and Directors Report must also be filed as must the list of shareholders and details of directors’ shareholdings. Where a company is a subsidiary, then it must disclose the name and registered office of its parent company and if a company is a parent company then it must list all subsidiaries together with certain details.

Companies, other than those who are audit exempt, are obliged to audit their accounts. Currently smaller companies whose turnover threshold is less than €7.3 million and whose balance sheet total is less than €3.6 million are exempt from this requirement. The audit exemption does not however exempt the company from filing accounts. All companies must file an annual return which must be done within six months of their birthday each year (the birthday being the date of incorporation of the company). Small companies are allowed to file an abbreviated balance sheet only, whereas medium-sized companies must file a profit and loss account together with an abbreviated balance sheet. For all other companies, they must file the balance sheet, profit and loss account, a director’s report, an auditor’s report and a statement of source and application of funds. It is also worth noting that even dormant subsidiaries must file their own separate accounts at present.
CORPORATE GOVERNANCE

Internal controls

Discussion of internal risk control is a key conversation for all boards in formulating a survival strategy – especially those now suffering distress during the economic downturn. Cost cutting, cash flow problems and employee turnover, each bring additional risk to a company’s internal control procedures. This is a time when a company is at heightened risk of fraud and other illegal behaviour like anti competitive practices. It is more important than ever to ensure that the procedures for controlling and managing risk are robust enough to withstand the added risks of difficult trading times.

The value of the company may have dropped, the level of losses incurred now worrying and, the order books thinning. This is the time the Board needs to re-evaluate its financial assumptions and to question the continuing appropriateness of how it manages its assets, liabilities, disclosures and transactions.

Given the greater recent attention to directors’ remuneration, it is opportune to look at both remuneration policy and disclosure. Changing economic conditions call the reliability of traditional performance measures into question and re-examining this may strengthen a company’s survival strategy. The Board should also review the effectiveness of it’s compliance regime, in particular it’s competition compliance programme and make sure it’s fit for purpose in these cartel inducing times. Recessionary times breed anti competitive practices, something which regulators are acutely aware of.

Troubled times mean companies may be more inclined than normal to take risks to improve solvency. In complex business transactions, risk may be effectively left to specialist staff, making it difficult for a Board to analyse it. However the Board should ensure that the risk fits with their overall business strategy and is within defined and controlled perimeters – be they authority based or financial. Reviewing those limits re-opens the debate on risk and focuses it on the changing economic circumstances. It is a basic and fundamental conversation for all boards. It in turn should improve managerial accountability and communications between management and the board. It may champion challenge – a clear pre-requisite for surviving the downturn. It should also help a board to understand the risks its suppliers, customers, contractors and distributors all face in their markets and that knowledge may help the company cushion itself against additional volatility.

Internal control of risk is not just about managing financial risk, it should also encompass operational risks that may hit indirectly through other stakeholders. A bad outbreak of swine flu among front line staff during a key trading period may be a risk that may not have been considered until recently. Collapsed property values may have been on the radar but they may have knock on implications that may need revisiting. Changing taxation regimes may also need to be addressed with a view to minimising any adverse consequences to the company.

Role of auditor

Traditionally audit firms have offered consultancy and tax advice which was seen as compromising their ability to carry out an independent audit of the same companies. There is now a requirement that the audit partner having responsibility for any particular company must rotate to avoid there being any danger of too cosy a relationship developing between client and auditor. This was seen to compromise the independence of auditors and a major weakness prior to 2002.

Further tightening of auditing standards has led to the requirement that public companies have an audit committee which chooses the external auditor and monitors, supervises and pays for the audit.
CORPORATE GOVERNANCE

Auditors now also have whistleblowing obligations. In the Irish context the auditor must opine on the directors’ statement of compliance for companies who are subject to it. They must report to the Director of Corporate Enforcement.

Directors

The obligations and responsibilities of directors emanate largely from common law, however, they have become increasingly enshrined in legislation. In addition, the definition of “director” is wide and can include non-executive directors, executive directors, shadow directors and nominee directors, all of whom are bound by a series of duties and responsibilities set out both by regulation and over time through case law.

The duties and responsibilities have been developed at common law, in other words, through decided case law over successive court judgements. The basic responsibilities are:

(i) to act in the best interests of shareholders;
(ii) avoid any conflict of interest between their own personal position and that of the company;
(iii) act with honesty and integrity.

Restrictions on directorships

There is a limitation on the number of directorships that a person may hold in Irish law. That limit currently is 25. The reason why it is so large is that many directors are directors also of subsidiary companies or securitisation vehicles. A securitisation vehicle is a creature of the IFSC and in order to nurture and encourage the securitisation industry it was felt that the upward limit on the number of directorships a person could hold is restrictive of the growth of securitisation companies. The Company Law Review Group has now recommended that securitisation companies be exempt from this limit.

Types of directorships

A shadow director is a person who controls the company without carrying out the formal duties of a director. Typically they may be investors or other persons who have a significant input and control over the company. They are essentially directors in all but name. A director who signed black cheques to be filled in by another was regarded as a shadow director.

A nominee director is a director appointed by a shareholder to protect that shareholder’s interest. They are typically nominated by banks and other investors.

An executive director is a director who also works in the company and draws a salary from it, whereas a non-executive director is somebody who is independent of the day-to-day running of the company but who sits on the board and directs its activities from there.

A non-executive director is a director who is not employed, therefore, by the company.

A sleeping director is usually a director who is named on paper, often a spouse or partner, but who in fact takes little or no part in the running of the company.

A registered director is one who is registered with the Companies Registration Office and whose name must appear on the headed notepaper and other communications from the company.
Non-executive directors

Effective boards usually contain a mix of executive and non-executive directors. The role of the non-executive director is to bring independence and expertise to the board which complement that of the executive directors. The role of the non-executive director has become increasingly important in recent years and is likely to become even more so in light of increased corporate governance and supervision of board activity. The idea of the non-executive director is that he or she can challenge and in doing so make more robust decisions of the whole board. They bring independence and an outside perspective thus ensuring greater accountability ultimately to the shareholders. Ideally the remuneration committee of the large companies should be made up of independent non-executive directors.

The average ratio of non-executive directors to executive directors in FTSE listed companies, is generally about 50-50. However, in the larger FTSE companies, the average in 2002 was six non-executive directors to four-and-a-half non-executive directors. When measured across the FTSE 250 companies, this fit was an even four both ways (Higgs Report, January 2003).

Duties of directors

The main duties of directors are set out in common law. In addition there are legislative duties of directors set out by the Companies Acts of 1963 to 2006.

Included amongst those legislative duties are:

- The duty to maintain proper books of accounts;
- The duty to prepare annual accounts;
- Duty to have an annual audit carried out (unless the company is audit exempt).

Each director is also obliged to record and file certain personal information which is then stored on the Companies Registration Office file. In addition, there are certain sector specific pieces of legislation which companies are obliged to adhere to and the responsibility for which ultimately rests with the directors of the company.

Some of those obligations will attract a personal liability for directors of the company, notably areas such as environmental issues or competition compliance. Any relaxation in a directors vigilance on these issues can become an especially thorny issue if a company enters into any court supervised wind-up or other rescue structure. Directors will be liable if the company did not properly record its accounts and will also attract personal liability where they conducted the affairs of their company in a way which indicated an intent to defraud creditors. Directors disregarding those obligations may well end up restricted or disqualified by the Director of Corporate Enforcement.

Directors and secretaries of limited companies must ensure that their companies comply with the requirements of the Companies Acts. All directors should be aware of their obligations and it is a good idea to brief directors occasionally on their legal responsibilities.

Overlaying the duties laid down in individual pieces of legislation there are also the overarching directors duties laid down by case law. Those duties can be summarised as follows:
CORPORATE GOVERNANCE

- Overall directors are required to act in the best interests of the company. Since 1990 directors are required to have regard to the interest of the company’s employees and members. It is also generally now accepted that where a company is in financial distress, directors also owe a duty to creditors to protect their interests;
- All directors owe a duty of loyalty and have a duty to avoid conflicts of interest;
- Directors have an obligation to adhere to the company’s internal rules set out in the Memorandum and Articles of Association;
- To avoid the making of secret profits. The directors have an obligation of care to carry out their functions with due care, skill and diligence;
- Directors must act in good faith.

Each of these obligations requires the exercise of judgement and cannot, therefore, be a “tick the box” exercise. The level of knowledge and expertise required of directors will be the same as would be expected of a reasonable person having the skill and knowledge that that director has. In other words, the higher the skill and expertise of a director the greater is expected of him or her simply by virtue of they’re being judged against the standards which would be expected of somebody with similar skills to themselves.

A director can be liable both under criminal law and civilly. Personal liability can attach both in the context of a director being guilty of negligence and also in the context of a director being guilty of default of obligation under the Companies Acts or under specific obligations such as those of health and safety or other sector requirements. For that, directors are entitled to have the company indemnify them for any liability incurred by them in managing the company. Directors and officers insurance is, however, expensive and will invariably be even more expensive if taken out at a time of crisis. Until 2003 directors and officers insurance was limited under Irish law but this has now been rectified and now Section 56 of the Companies (Auditing and Accounting) Act 2003 allows the company to take out directors and officers insurance for civil liability.

Company contracts

Currently limited companies are restricted in the activities they can carry on by their own so called “Objects Clause” in the Memorandum and Articles of Association - the constitution of the company. When a company establishes itself it must set out in its Objects Clause what business it intends to undertake and normally covers that with all sorts of ancillary objects which it may need. While it is not usually a problem, occasionally companies may change direction and may have failed to provide for that change in direction either in its original Objects Clause or by failing to amend it. Where this happens a company may well find itself trading “ultra vires” and “or outside of its own authority”. Where this happens and the company has entered into contracts for that new and unauthorised business then there may be legal difficulties in enforcing those contracts.

The Company Law Review Group has recommended that this “ultra vires” rule would be abolished and this is likely to happen in the near future. However, until then directors need to be careful that the contracts that they enter into do have the proper legal authority. It is a good idea for each director to be familiar with the company’s Memorandum and Articles of Association which are companies founding documents.

Loans to directors

Also prohibited is the provision of a company of a loan or similar credit transaction to one of its directors. There are a number of exceptions to this and generally loans are allowed where the total value is less than 10% of the company’s assets. Guarantees for a loan are allowed where the
shareholders allow it and the directors swear statutory declarations of solvency. Also allowed are loans or similar type transactions in favour of a director or someone closely connected to that director which are entered into in the ordinary course of business and are at arms length. Ireland’s 10% threshold is unique. While 10% of assets may in the overall context be a relatively small sum, nevertheless where markets fall as significantly as they have in recent times, the 10% threshold takes on a much higher significance.

In many cases directors’ loans are no harm. The majority of our companies are owner-managed companies and, therefore, the company lending to one of its directors is in most instances actually lending to its owner who will invariably be required to give a personal guarantee to banks to secure the company’s corporate borrowings in any event. So some degree of flexibility for the small owner-managed companies is required. The UK has substantially lessened the prohibition on these sorts of transactions and the Irish Company Law Review Group has recently considered doing likewise here.

The recommended changes are:

(i) that loans to directors are put into writing. If it has not been put into writing then there will be an automatic assumption that the loan is repayable on demand and at commercial interest rates;

(ii) where a director has made a loan to the company and the loan has not been put in writing then the loan will be assumed to be interest free and unsecured.

The Director of Corporate Enforcement has reported that in 2008 there has been a fourfold increase in the reported amount of company funds being used by directors for personal purposes. He goes on to state that “we have no wish or desire to see directors sanctioned for ordinary business failure, but we will wish to see directors who act illegally or who do not act honestly or responsibly face the full rigor of the law”. Those loans were mainly in the construction and property sector and amounted to €134 million for 2008.

Insider dealing

Insider dealing by company directors has long been recognised as an economic danger to the economy and was first made a criminal offence in the USA in the aftermath of the 1929 stock-market crash. The law has been successfully fine-tuned and strengthened over the years, however, it is generally regarded as difficult to get a successful prosecution given that investment is global, and certain countries, such as Leichenstein, the Bahamas and the Cayman Islands, shield company information. The European Union’s anti-insider dealing laws date back to 1989. It was out of the 1992 directive that Ireland carved it’s own anti-insider dealing legislation under Part V of the Companies Act 1990.

The insider dealing rules prohibit transactions based on confidential price sensitive information and this covers not just directors but also employees, shareholders, advisors such as auditors or solicitors or liquidators or others having a confidential relationship within the company or to the company². Basically any person who has a relationship with the company such that would allow them access to share price sensitive information that is not publicly available. Also recognised and prohibited is the idea of an insider “tipping” an outsider. There are exceptions to the insider dealing rule and they include shares willed to an insider or shares acquired by an employee as part of a company profit-sharing scheme.

² Those with ‘managerial responsibilities’ within listed companies must notify the company and regulator of any investment transactions by them.
The market in shares is increasingly complex and relies on investor confidence in the economy in general as well as in individual companies. That confidence can be relatively easily damaged by allegations of insider dealing. While the law may prohibit it, it can be a difficult concept to prove. It is part of the reason why the Director of Corporate Enforcement has sought the provision of whistleblowing in Irish company law. Irish legislation makes insider dealing a criminal offence.

The law regulates insider dealing in a number of ways. Under the 1990 Act there is a general prohibition against companies and directors dealing in the shares of their own companies. This is to avoid a situation where directors take advantage of information to which they are privy in order to enrich themselves. Obviously any large purchase of shares can materially affect the price of that share. In addition to the Companies Acts legislating against insider dealing, the Stock Exchange has its own particular requirements and Irish Financial Services Regulatory Authority (IFSRA) also have enforcement powers under the Market Abuse Regulations of 2005 which, in the main, set out the insider dealing rules applying to listed companies. 3

The Companies Acts allow a limited amount of insider dealing and this really is aimed at allowing companies to give shares to its directors as an incentive. There are, however, limitations to this. In addition to there being restrictions on directors owning share in the company, there are also restrictions on companies acquiring its own shares and providing financial assistance to others to own shares in the company.

Under the 1990 Companies Act, a company may buy its own shares. Some limitations are:

(i) The purchase must be approved by shareholders;
(ii) The prohibition on a company purchasing its own shares applies only to limited companies, therefore, those who take on the mantle of unlimited liability are not subject to the same restrictions;
(iii) A company can redeem preference shares or indeed can acquire shares if they are trying to reduce its own share capital. Where it does decide that it needs to purchase its own shares, then there is a regime in place under the 1990 Act. In such a case a company can only fund such a purchase from its profits. There may be instances where a company shareholder wishes to sell back his shareholding to the company. Where a company does purchase its own shares then it must publicly disclose that.

There is prohibition on a company giving financial assistance to others to buy its own shares. The main intent is to prohibit a company giving money to another to acquire it and it is also important as a creditor protection. There is some degree of financial assistance allowed, provided the shareholders approve and the directors have carefully considered the implications and the potential difficulty were the company to become insolvent.

Directing during troubled times

The responsibilities of directors grow in risky times. For distressed companies, when the company becomes seriously at risk of insolvency greater vigilance is expected of directors. This increased vigilance is needed because a director is now obliged to have regard also to the interests of the company’s creditors. Prior to this the director had an obligation to act in the best interests of the company’s shareholders and employees. Now the creditors get a look in. If a director realises or should realise that there is no reasonable prospects of saving the company from insolvency, then they must take every step to minimise loss to the creditors. Often this realisation crystallises when it is

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3 Listed companies must keep a regularly updated list of those who possess inside information and must give it to the Stock Exchange upon request.
CORPORATE GOVERNANCE

clear the company is not in a position to pay a large creditor, such as the bank, or where orders have dried up, the company is unable to pay its debts, and, what the company has in assets is insufficient to meet its liabilities. Transactions entered into at an undervalue at this time can be set aside where the transaction involved the company receiving materially less than it should have.

When a company is at or near insolvency directors must make sure that the actions that they take have the best interests of the business at heart and must be made having regard to creditors.

But which creditors? It is possible that satisfying one block of creditors may disadvantage others. In that event, it is a judgement call for the directors and that judgement is based on the reasonableness of their actions given their level of skill and knowledge. If the company goes into liquidation, the liquidator may ask the court to put aside any transaction which has been entered into by the company which was at an undervalue. This may also lead to the directors being asked to make up the difference in value. Such transactions are open to scrutiny if entered into within the two years prior to the company’s insolvency – the time of insolvency being ascertained per the accounts of the company and not necessarily at the time the liquidator is appointed.

It is not a given that the court will set aside a transaction at an undervalue as they will look at all the circumstances and that may include whether the directors had a reasonable belief at the time of entering into the transaction that it would benefit the company in which case it will be allowed. So a company selling an asset at an undervalue knowing that it was in trouble but knowing that it needed the money to continue will not necessarily be struck down providing the directors acted in good faith and their decision was reasonably made at the time.

Under Section 204 of the Companies Act 1990, a liquidator may apply to have a director held personally liable for the company’s debts if it failed to maintain proper books of accounts and if that failure led to or contributed substantially to the company’s demise. Liquidators are obliged to report to the Office of the Director of Corporate Enforcement (ODCE) on the behaviour of the company’s directors. There was a 42% increase in the number of initial liquidators’ reports received in 2008.

Reckless, fraudulent and wrongful trading

What is reckless trading? Section 135 of the Companies Act 1993 states that “a director cannot cause or allow a business to be “carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors””. In other words continuing to trade and to spend money when the director knows that the company will not be able to pay its debts may amount to reckless trading. If the director has an honest and reasonable expectation that the company will be able to repay its debts that does not generally amount to reckless trading. Reckless trading, therefore, requires that the director actively and recklessly puts creditors money at risk.

Fraudulent trading is a different kettle of fish. It does not necessarily involve evidence of a fraud. However, it does involve trading with the intent to defraud creditors or any other person. It is essentially dishonest trading as against recklessly irresponsible trading.

So what is fraudulent trading? Fraudulent trading is a crime involving the carrying on of a business with intent to defraud creditors or for any other fraudulent purpose. While aimed at directors it could also be carried out by other officers of the company.

Wrongful trading arises where a company continues to trade despite the fact that the directors knew or should have known that there was no reasonable prospect of the company surviving and where notwithstanding that, failed to protect the creditors against loss.
A director found guilty of wrongful trading is likely to be either restricted or disqualified by the High Court upon application of the Office of Director of Corporate Enforcement. This may arise simply because of the liquidators obligation to whistle blow or indeed it may arise from proceedings taken against the insolvent company. Any director found guilty of wrongful trading may also be required to make a personal contribution to the assets of the insolvent company and that contribution would be the amount by which the company's assets have been depleted by the director's conduct. This is regardless of whether or not there was fraudulent intent on the part of the director in question.

Restriction and disqualification of directors

A director can either be restricted or disqualified in this jurisdiction. The restriction process essentially restricts a director’s ability to become involved in other companies in the future. It is a step down from disqualification and will generally only apply where the director has behaved irresponsibly or dishonestly. It is designed to reign-in the phoenix-like syndrome where a company director could close down one company without paying its debts and then just start afresh.

In 2008 there were 20 director disqualifications and one restriction order made. Where a director is deemed by the High Court to be unfit to run a company, they are likely to be disqualified. Where they have been blameworthy but not necessarily unfit, they may be restricted. Restriction orders, however, are few and far between.

All liquidators must, under Section 56 of the Company Law Enforcement Act 2001, report to the ODCE within six months of their appointment. While most of these reports have not led to directors being disqualified or restricted, it is likely now that in hard times the number of restrictions and disqualifications arising from insolvency will increase. A restriction order can be made against a person who is a director of an insolvent company within twelve months of the commencement of its winding up. It is made under Section 150 of the 1990 Companies Act and will be made unless the director can show generally that he acted honestly and reasonably. Any company taking on a restricted director has certain additional share capital requirements and share dealing prohibitions.

Whether a company director has acted reasonably or not has been considered by the Irish Supreme Court. It adopted criteria set out by a UK case on the same question and those criteria were:

1. extent to which directors complied with the obligations imposed by the Companies Acts.
2. extent to which the director’s conduct could be regarded as so incompetent as to amount to irresponsibility.
3. extent of the director’s responsibility for the insolvency of the company.
4. extent of the director’s responsibility for the net deficiency in the assets of the company disclosed at the date of winding up or thereafter, and
5. extent to which the director displayed ‘a lack of commercial probity or want of proper standards’.

A director who has been restricted may apply within twelve months of making of the order to have it lifted.

Under Section 160 of the 1990 Act, a director who is convicted or serious offence involving fraud or dishonesty will be automatically disqualified. There is also a discretionary power to disqualify directors for a range of other behaviours including reckless trading, breach of duty and persistent document default. At the same time a director may also be made personally liable for the debts of the company and may indeed have to give back some of the remuneration earned from the company.
Key questions for directors

Have you acted honestly and responsibly?

Remember you can only do your best. Your judgement may have been poor, but that does not necessarily mean that you have been dishonest or irresponsible. You may have been slow to react but that doesn’t mean that you can be held guilty of neglect. You may have misjudged the situation but that too may be okay.

But did you spend monies you knew without doubt you did not have? Then you may not have acted honestly and responsibly.

What should a director do in these troubled times?

1. Keep a close eye on the finances;
2. Make sure they have up-to-date and accurate information on the financial position of the company and its cashflow;
3. Keep any new commitments to a minimum;
4. Do not take on new creditors if you know full well that you won’t be able to pay them;
5. Avoid any conflicts of interest and, in particular, transactions that are at an undervalue, especially if they involve family and friends;
6. It is worth noting that the courts can lift the “veil of incorporation” to look at the true ownership of the company if “the justice of the case so requires it”;
7. Get independent evaluation for the disposal of any significant asset;
8. Carefully minute board meetings where the company is near insolvency. You may need them to show that you acted honestly and reasonably at a later stage;
9. Don’t be afraid to take advice.

Further information

OECD Principles of Corporate Governance

Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member States
