



Director's Duties and Obligations – Business in Financial Difficulty

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A hand holding a pen pointing at a tablet displaying financial charts.

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Introduction

Recently there has been much commentary on the prospect of a large increase in company insolvencies arising from the COVID-19 pandemic, along with an increasingly turbulent macro economic environment.

While this is useful commentary, it is important that boards of directors understand their duties and obligations if their business is in financial difficulty or at risk of insolvency, and also what immediate actions need to be taken.

A high volume of corporate insolvencies has been avoided due to various government supports, tax warehousing and creditor forbearance.

The level of insolvencies since the onset of the COVID-19 pandemic in March 2020 has been widely described as artificially low.

At present there is a lot of uncertainty and potential financial difficulty facing businesses. These challenges will impact businesses in different ways but will result in increased costs, higher costs of debt, potentially reduced demand and output disruption.

Statutory duties & obligations

The European Union (Preventive Restructuring) Regulations 2022 (the “Regulations”) were signed on 27 July 2022 to give effect to an EU directive (Directive (EU) 2019/1023).

The Regulations introduce changes to the provisions of the Companies Act 2014 giving statutory recognition to the duty to have regard to creditors’ interests.

Traditionally the fiduciary duties of directors, as set out in the 2014 Act, are extended in situations where a company is insolvent, requiring directors to have regard to the interests of the company’s creditors.

Significantly the Regulations for the first time place a statutory obligation on the directors to have regard to the interests of the company’s creditors “where the directors become aware of the company’s insolvency”.

The new statutory fiduciary duties of directors are enforceable in the same manner as a breach in the traditional fiduciary duties of directors (discussed later).

Directors concerned about a company’s financial position should take professional advice as to his/her legal obligations but also on potential solutions to deal with the company’s financial position.

Warning signs

Businesses will need to analyse whether they can survive and if not, explore the various restructuring options available to them.

Directors should be cognisant of the warning signs (discussed later) of financial distress.

Delaying decisions on seeking professional advice and / or taking steps to try to resolve a company’s financial difficulties, will likely worsen its financial position, resulting in a lower chance of ultimately avoiding closure.

It is important that directors recognise their responsibilities and duties with regards to shareholders and creditors during times of financial uncertainty, and the potential consequences if the right actions are not taken, for the directors personally as well as the business they manage.

These warning signs are explored in more detail overleaf.



Signs of Financial Distress

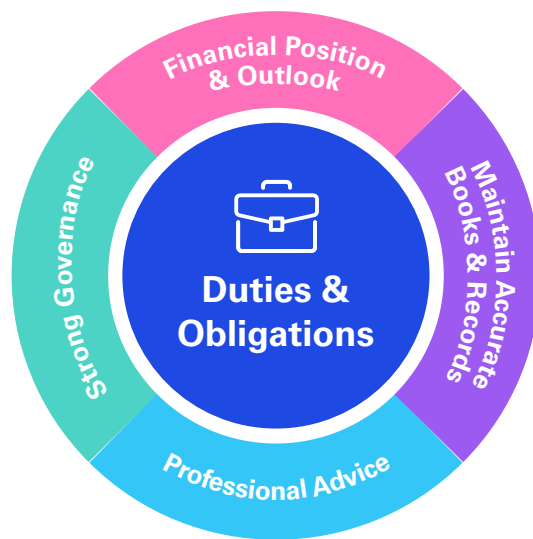
Falling sales	Tax arrears building / non-filing of tax returns	Cash flow projections showing deficiency which cannot be funded
Poor liquidity ratios (i.e. current, cash)	Refinance applications are being refused	Little interest in buying the business / part thereof
Cash flow difficulties	Being placed on stop supply / stop credit or cash on delivery	Legal demands / judgement debts
Loss of major customer / client	Repayment plans with creditors	Delay in payment / non-payment of staff wages
Bank overdraft is constantly at its limit	Rent and other essential services unpaid or delayed	Receive eviction notice from landlord
Directors not taking a salary	Large bad debt write-offs or provisioning	Tax arrears notices / demands from the Revenue Commissioners
Aged creditors worsening / credit terms stretched	Disputes with auditors in relation to audit opinion / presentation of financial statements	Receive a petition to wind up from a creditor
Debtors consistently paying late	Demands from uncontested creditors	Creditors requesting return of stock under Retention of Title
Trading losses are occurring	Partial payments being made, i.e. instalments	



Businesses in financial difficulty will not face all of the above issues, but these are typically what is encountered with some issues arising earlier than others. A build up of these issues without planning or decisive action taken by a board may leave it too late for a business to explore feasible restructuring solutions.

Director's Duties & Obligations

In the normal course of business directors' fiduciary and statutory duties are owed to the company, and its shareholders.



Section 228 of the Companies Act 2014 sets out the statutory duties of directors:

- Act in good faith in what the director considers to be the interests of the company;
- Act honestly and responsibly in relation to the conduct of the affairs of the company;
- Act in accordance with the company's constitution and exercise his or her powers only for the purposes allowed by law;
- Not to use the company's property, information or opportunities for his or her own or anyone else's benefit (unless in specific allowed circumstances);
- Not to agree to a restriction of his/her exercise of independent judgement (unless in specific allowed circumstances);
- To avoid any conflict of interest between the director's duties to the company and his/her own interests (unless in specified allowed circumstances);
- To exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person;
- To have regard to the interests of the members of the company, in addition to the duty under section 224 to have regard to the interests of the company's employees in general.

Business in Financial Difficulty

- In times of financial uncertainty, directors continue to owe their duties to the company, but must take the interest of creditors into account.
- As explained earlier there is now a statutory obligation on directors to have regard to the interests of the company's creditors in situations where a company is insolvent.
- Overleaf we set out the two tests which determine whether a company is insolvent, along with the practical steps to be taken by boards of companies that are in financial difficulty.
- Many companies may be doing this already but if not, it is very important to adopt a similar approach to ensure a board is fully aware of a company's financial difficulties and also, be in a position to react to these difficulties as soon as possible, with the business hopefully trading out of its financial difficulties or successfully exiting a formal restructuring process.
- If a board takes these practical steps, it can be demonstrated to a Liquidator that the board were trying to act in the interests of its creditors. This approach does not absolve directors of other offences which may have been committed but it can go a long way to showing that the directors were taking a practical approach to address its financial difficulties.



Company Insolvency Test

Two tests that determine whether a company is insolvent are the Cash Flow test and the Balance Sheet test.



Cash Flow Test

- Insolvent on a cash flow basis
- Can the company pay its debts as they fall due
- Short term / immediate focus



Balance Sheet Test

- Insolvent on a Balance Sheet basis
- Does the company's liabilities exceed its assets
- Longer term focus

Key Considerations

- Can the company trade out of its financial difficulties?
- Reasons for underperformance / liquidity problems?
- What are the company's prospects over the medium / long term?
- What is required to keep the business afloat?
- Disposal of part of business / assets to generate funds?
- Ability to raise finance or refinance secured debt position?
- Threats of enforcement from creditors?

Cash Flow Test

In terms of the cash flow test, the question is can a company pay its debts as they fall due. This shows the importance of a board preparing regular and detailed cash flow projections with focus on the immediate or short term cash flow requirements for a company, and should identify the funding requirements for a business to continue to trade.

Balance Sheet Test

The Balance Sheet test must also be applied to show whether the Company has sufficient assets to discharge its liabilities. This test would also focus on whether it can meet its longer term liabilities over time based on its asset position.



Practical steps to take when facing financial difficulty



Maintain Accurate Books & Records

All financial information should be accurate and up to date to ensure decisions are made by management and the board of directors are based on a clear picture of the company's financial position.

Out of date information is of little use, especially when a company is in financial difficulty.

Summarised below are recommended board pack contents which a board can use to continuously assess the financial position and future viability of its business.

A board pack should ideally include:

- Latest cash flow position
- Latest set of management accounts
- Latest cash flow & trading projections
- Up to date creditor balances outlining movement by creditor since previous update / during the relevant period
- Update on progress with funding / refinance options possibly being explored by the company
- Update on any discussions with creditors – commitments given etc
- Depending on the nature of business other trading KPI's may also be monitored and included in board packs for discussion and ongoing monitoring.



Practical steps to take when facing financial difficulty

Financial Position & Outlook

- A business plan for the next 12 months should be prepared, with realistic targets and outcomes projected by management and the board. The plan should also address what investment / financing is required to keep the business afloat.
- The plan would need to contain financial projections for the 12 months but it is critical to prepare and maintain conservative cash flow projections which are appropriately stress tested across a number of scenarios.
- This illustrates the impact of certain unfavourable and potentially favourable events on the company's financial position, and what corrective action (if any) can be taken.
- Has the company adjusted its financial projections to account for inflation, rise in interest rates, any labour shortages (reducing capacity to deliver turnover targets), removal of government supports, fall in demand for its goods / services, loss of customers etc?
- There needs to be close focus on the working capital position of the company and can it be improved e.g. can debtors be collected quicker, can stock levels be reduced to more appropriate levels, more focus on aging creditors and are credit terms manageable.
- Immediate steps should be taken to cut costs where possible in order to reduce losses and minimise exposure to creditors, although this might not always be appropriate depending on current circumstances.
- All funding / finance options must be considered by the directors e.g. shareholder investment, disposal of non-core assets to fund the business, loan finance, refinance current loan facilities etc.
- Continuously monitor projections and adjust where necessary for recent or expected trends e.g. unexpected fall in turnover, rise in cost of certain raw materials / goods / services.
- Review details of all movements in key metrics such as introduction of new funding, movement in creditor levels





Practical steps to take when facing financial difficulty



Strong Governance

- Strong governance which should be the norm for all companies, is critical in times of uncertainty / financial difficulty.
- Informed decisions can be made by a board but this approach should document key decisions made, and the basis of these decisions.
- Through strong governance and documented decision making, the creditors' interests must be shown to have been put first.

- If it is recognised that the company is insolvent and the board are exploring restructuring / financing options, only payments critical to preserving value in the business / allowing it to continue to operate should be approved.
- In a subsequent liquidation this will show a Liquidator how the board contemplated certain key decisions and why certain actions were taken e.g. why certain creditors were paid, in order to keep the business functioning.
- Frequent board meetings should be held to review the latest financial information / board packs etc.
- Good records of all key decisions should be kept by a company recording at least the following:
 - What information was relied on?
 - Was any professional advice obtained and / or considered?
 - Documentation of the decision with accurate minutes.

Professional Advice

- A sensible approach for boards can be to take professional advice from insolvency experts (insolvency practitioners / accountants / solicitors).
- This advice can set out options for a board and recommended steps to take given a company's financial position.
- Also, if the directors are considering a disposal of the company's assets, they should take legal advice on the appropriateness of the transaction and whether it is ultimately in the interests of the creditors of the company.
- The board obtaining expert advice mitigates risk of error and potentially worsening the financial position of the company to the detriment of its creditors.



Common Errors & Risks For Directors



Common pitfalls / errors

- Not holding regular board meetings and documenting all correspondence / discussions.
- Ceasing to trade when continuing to trade would have preserved creditor / asset value better
- Making unfair preference payments in the lead up to a company's liquidation.
- Failing to file any tax returns with the Revenue Commissioners. While businesses may not be able to make payment of the tax liabilities it is important that the tax returns are kept up to date.
- Failing to keep management accounts / financial statements up to date.
- Failing to engage with creditors in any capacity.
- Failing to consider the appointment of an Examiner / Liquidator / Process Advisor.
- Failing to seek professional / legal advice on the insolvent position of the company and the best course of action to take.
- Attempting to trade out of insolvency when not appropriate to do so.



Common Errors & Risks For Directors

Risks for Directors for breach of statutory obligations / fiduciary duties



Restriction / Disqualification

If a Liquidator is not satisfied a director acted honestly and responsibly in relation to a company's affairs, the Liquidator must apply to the High Court for the restriction of the director.

A restriction order results in a director being restricted from acting as an officer of a company unless that company has a paid up share capital of €100,000 in the case of private companies or €500,000 in the case of public companies.

A Liquidator may apply for the disqualification of a director if it is deemed he / she is "unfit to be concerned in the management of a company". A person can also be disqualified if they have been convicted of a criminal offence.

A disqualified director cannot act as an officer of a company or be involved in the promotion, formation or management of any company.



Reckless Trading

A director may be made personally liable for the debts of an insolvent company if they knowingly carried on the business in a reckless manner i.e. where he/she should have known that their actions would cause loss to the creditors or where they allowed the company to incur debt when it was known that the debt would not be paid as it fell due.



Fraudulent Trading

A director may be held personally liable for the liabilities of an insolvent company where he / she knowingly carries on the business with intent to defraud creditors.



Failure to Keep Proper Books & Records

It is a criminal offence for a company to fail to keep proper books and records. It is also a criminal offence if a company director fails to take all reasonable steps to make sure that the company keeps proper books and records.

A Liquidator can apply to Court to seek to have a director made personally liable for all the debts of the company where his/her failure to maintain proper books and records has contributed to the company's insolvency and has disrupted the winding up of a company.

Contact

If you are a director of a company that you believe is facing financial difficulty and wish to receive some advice on the matter, please do not hesitate to contact the Restructuring and Forensics Department at KPMG Ireland.



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