



Business Recovery & Insolvency Newsletter

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Boiled frog syndrome is a business metaphor - when a frog is dropped in boiling water, the frog immediately jumps out; however if the frog is placed in water and the temperature increased slowly, the frog will not jump but boil to death. The frog recognises an event of sudden danger, but not danger that develops incrementally.

Richardson et al* developed the 'boiled frog' theme to explain small business failure.

The 'tadpole' is the start up that never survives past its early stages. It fails because of over-optimism, a failure to make contingency plans and a lack of focus on overall success as a result of blinkered product focus.

The 'drowned frog' is the business that swims from one bright idea to the next. It fails because of hyperactive over-ambitious management, the failed ambitious entrepreneur of a SME or in a bigger context this is the failed conglomerate kingmaker.

The 'boiled frog' fails to adapt to change. These are long established organisations which exhibit introversion and inertia.

The 'bull frog' is the expensive show off which needs to adorn itself with the trappings of success. The business fails because of a dominant manager, the occurrence of fraud or unethical behaviour. It can also be the business owner who places his own short term selfish needs ahead of the needs of his

business, ranging from small firm flash right up to the megalomaniac.

Many struggling businesses fail to adjust to gradually deteriorating conditions and fail to make needed changes. Why are companies so reluctant to ask for help?

Why do businesses wait? Many feel they should be able to turn things around themselves. Others do not want to air their dirty laundry or take their heads out of the sand. Many do not want to take difficult decisions or let down colleagues and friends.

The Business Restructuring and Insolvency Team at Geldards has helped many struggling businesses over the years, through formal and informal restructuring.

The team's ability to quickly understand a business and assess the various stakeholders' positions is one of its key strengths. One size does not fit all in business and the team bring with them a breadth of commercial experience as well as a depth of legal knowledge in order to provide bespoke answers in challenging times. Each client is unique and so is its business.

Identifying an issue early ensures that there are more options for dealing with it. If it turns out that everything is fine, great; no more insomnia. In the unhappy event that all is not fine then there will be options, but those options tend to decrease with time.

We are happy to talk. Save the frog; don't let it boil...





→ Head Banging In The Twilight Zone



*“I try to show her that she’s never gonna be alone,
Because my spirit is imprisoned in the Twilight Zone”*

Directors can sometimes feel that they are banging their heads against a wall as the financial difficulties force them to tread that fine line between acting rashly and not acting in time.

Causing a company to cease to trade or putting it into administration or liquidation prematurely may be as damaging to the interests of the creditors as allowing a company to carry on trading.

It has been written that very significant value was lost from Lehmann Bros because the decision to commence formal insolvency was taken prematurely without considering the consequences of doing so.

Conflicting Duties?

Directors must act responsibly, resisting on the one hand, their natural tendency to be over-optimistic and to not admit defeat and, on the other hand, the temptation to throw in the towel without considering the options available.

Their analysis of their company’s performance and prospects should be based on up-to-date financial information and should almost certainly involve consultation with professional legal and financial advisers.

In the ordinary course of business, the duties of directors are to the company and its shareholders, but upon the approach of insolvency, the priorities change.

That duty shifts so that directors are obliged to act to safeguard the interests of their creditors instead. The problem is that the point in time at which the insolvency of the company actually occurred is later judged with the benefit of 20:20 hind-sight, when the directors’ actions come under the close scrutiny of the Insolvency Practitioner (IP).

This applies to directors and shadow directors alike.

Under insolvency legislation a director will be liable personally for wrongful





trading if a liquidator can show that they knew or ought to have concluded there was no reasonable prospect of avoiding liquidation but continued to do business as “normal”. Therefore, anticipatory protective steps by directors are crucial.

It is frequently our role as insolvency lawyers to advise directors of their duties and to ensure that they have taken every step with a view to minimising the potential loss to the company’s creditors as a whole. Liability will not arise if the director can show, to the court’s satisfaction, that they took all reasonable steps to minimise the potential loss to the company’s creditors.

In judging whether a director has taken account of the right facts, reached the right conclusions and taken the appropriate steps to protect creditors, the director’s actions are assessed by applying a two-fold skill test.

The standard expected is that of a reasonably diligent person having both the skill and experience possessed by a reasonable director, together with the skill and experience actually possessed by that particular director.

The general level of skill expected of all directors is required under the first part of the test. Under the second part, a higher standard of knowledge and skill is required for those with relevant specialist skills, for example legal or accountancy skills.

Consequences

There are three main consequences for the director. The first is financial and the second two are reputational:

- Personal contribution: the director may be made to contribute personally to the assets of the insolvent company for the losses caused to the creditors of the company from the point in time at which the director ought to have stopped trading and incurring new credit. This is unlimited in amount.
- Disqualification as a director: A director can be disqualified for a minimum of two and a maximum of 15 years. The IP is

required to report delinquent directors to the Department for Business Enterprise and Regulatory Reform. There were over 1,000 disqualifications of directors in 2007/2008.

- Disclosure in capital raising documents: The director will be obliged to expressly state in any fund raising memorandum that he has been a director of a company that has gone into an insolvency process in the previous five years.

Formulating A Viable Strategy

This will generally involve the preparation of regular statements of affairs, cash-flow projections and other current financial information, in collaboration with auditors and other advisers as necessary.

The board should then formulate a strategy for restoring the company to a healthy financial position and avoiding formal insolvency proceedings.

Prudent directors might consider alternative trading strategies, disposals, maximising existing asset values, cutting overheads, delaying capital investment, further bank finance (possibly with a grant of security), converting debt to equity, raising new equity, an informal arrangement with major creditors or a voluntary arrangement.

Where trading continues, new credit should not be incurred without proper regard to how it will be paid for. The strategy needs to be realistic (as opposed to optimistic) and it needs to be “stress-tested”.

The question “but what if?” should be used, and used often.

Where a restructuring or rescue is pursued, there should be a contingency plan in case it fails. The chosen strategy must have the support of the board. In addition, its viability must be reviewed by appropriate advisers and its implementation constantly monitored.





Holding Regular Meetings

Board meetings should be held on a regular basis with a regular review of management accounts. Detailed records should be maintained of all board decisions and the manner in which they were reached to ensure there is evidence of a clear and cogent basis for those decisions.

Actions taken in the interests of the company and its creditors should be methodically documented and explained. Directors must give reasons for their decisions and cite the advice they have taken. They should also document why alternative options or strategies were discounted.

The more precarious the state of the company, the more frequently the board meetings should be held. In some cases daily telephone board meetings may be appropriate. Directors who want to do this by telephone or by video conference need make sure that their company's articles of association allow this. The minutes of those meetings should be circulated, confirmed and signed off in a timely manner. They may well be scrutinised by an IP or a judge months or even years later when no-one can recall what was said.

Revisiting the Strategy

Repeated consideration should be given to the conclusion that there is a reasonable prospect of avoiding insolvent liquidation.

The factors that underlay the development of the strategy should be revisited and reconsidered. Are the underlying assumptions (for example, as to the value of properties/assets) still reasonable?

The accounting principles upon which assets are valued for the purposes of the annual statutory accounts might not be appropriate. What would they raise if they had to be sold as quickly as possible in today's market?

The realisable value of any asset will, of course, depend upon all the circumstances in which the asset is being sold. Discussions with a company's auditors and valuers

may be helpful on this point.

Directors should have proper risk analysis procedures in place. These enable dangers to the business to be identified and wherever possible minimised or contingency plans agreed, so the risks can be managed in the most effective way.

Risk management should be a part of any business strategy, but it is even more important if solvency is an issue.

Additional meetings should be called as and when significant new events occur. Absent directors should be told as soon as possible of critical decisions taken at board meetings.

Professional Advice

Existing advisers should be involved in discussions and in the development of strategy but only if they are qualified to advise in cases of financial difficulty.

A company might be well advised to retain an IP to advise on the strategies available. It is also often our role as lawyers to help to determine whether a proposed transaction could be vulnerable as a preference or is otherwise inappropriate.

Accurate, complete and up-to-date information, coupled with financial and legal advice from appropriately qualified professionals will significantly strengthen a director's position. They would, for example, be vital in justifying a director's actions if faced with a claim for wrongful trading.

A court will be reluctant to substitute its own commercial judgment for that of a director unless it considers that no reasonable director could have concluded that the action taken was in the interests of the company or its creditors.

In cases where directors have acted on the advice of properly qualified, competent professionals, judges are unlikely to assert that they know better.





Conflicts of Interest

All directors should separate their own personal interest (as shareholder, executive, creditor etc.) from the company's interests. Their duty is to act in the best interests of the company. Board members should avoid or declare any conflicts of interest fully at the earliest opportunity.

Any conflict must be authorised in accordance with the Companies Act 2006 and the company's articles of association. The other members of the board should adopt appropriate procedures such as the formation of appropriate committees to make it clear that any conflict did not affect board decisions. This is particularly important if a director or a number of directors wish to buy some or all of the assets from an administrator or liquidator.

In some circumstances, there may be a conflict of interest between a subsidiary company and its parent or between fellow subsidiary companies, requiring separate legal and/or financial advice; for example, where it is proposed to use the assets of a doubtfully solvent subsidiary to secure the parent's indebtedness.

Directors may need to seek advice individually on how to minimise the personal risks involved in the management of a company that is approaching insolvency.

Individual directors should raise any concerns over solvency with other members of the board and ensure those concerns are recorded in the board minutes or otherwise in writing. If their fears are not heeded, they should repeat their concerns and take steps to protect their own position in case the company's position worsens.

Directors who can show that they acted in good faith on the advice of suitably qualified professionals will be more likely to avoid wrongful trading allegations, even if the liquidator believes the advice they were given was wrong.

Keeping Major Creditors Informed

It may be advisable that specific directors handle discussions with the company's bankers and other major creditors.

It is important that the distribution of information to creditor groups is handled in an orderly way. Information to be released to creditors should be discussed with and, in some circumstances, presented by, the company's advisers.

Where a strategy to be implemented requires creditors' support (principally that of the lending banks), a careful and clear presentation is required based upon careful consideration of the creditors' options if they do not like what they are told.

Directors of companies in difficulty are often surprised that key suppliers or creditors informed of the situation are often willing to support the business by continuing supplies or extending credit. It is important that any disclosure is not misleading and that suppliers and creditors receiving the information agree to keep it confidential.

Board members and any other party receiving information should treat the financial position of the company as commercially sensitive information which must be kept entirely confidential, unless disclosure is required for regulatory or overwhelming commercial reasons. If this situation does arise, it is appropriate to make sure that the person receiving such information first signs a legally binding confidentiality undertaking.

If the company's shares are traded on the London Stock Exchange or on the Alternative Investment Market (AIM), there are a series of obligations concerned with the release of commercially sensitive information to the market and with behaviour that may have the effect of distorting the market in that company's shares. These include not only the Disclosure and Transparency Rules and AIM Rules relating to disclosure of information, but also the market abuse and inside information regimes and the offence of misleading statements and practices. These rules are very complex, and are not dealt with





further in this article.

To take just one example, when a listed company's financial situation deteriorates, certain announcements have to be made to avoid the creation of a false market in the company's shares. Announcing that a dividend might not be paid, or that a company is in discussion with its bankers, will obviously have a marked effect on creditor confidence. Therefore, directors will need to consult their advisers about the timing and content of announcements.

The Companies Act 2006 ('the Act').

Under the existing common law, when a company's financial position has deteriorated to the point where its solvency is in question, the focus of the directors' attention must shift away from the shareholders towards protecting the interests of creditors. This is the position classically set out in **West Mercia Safetywear Ltd (in liquidation) -v- Dodd**.

Most of the current law on directors' duties, including the additional duties that apply on or in contemplation of a company's insolvency, has been developed by the courts over many years.

The Act has recently codified the core duties in a statement of directors' duties, known as the General Duties. There are duties:

- to act within the company's constitution and only exercise powers for a proper purpose;
- to act in good faith to promote the success of the company;
- to exercise independent judgement [this does not restrict a director seeking informed advice];
- to exercise reasonable care, skill and diligence;
- to avoid conflicts of interest;
- not to accept benefits from third parties; and

- to declare interests in proposed transactions or arrangements with the company.

The aim of the Act was to make the law in the area of directors' duties more consistent, certain, accessible and comprehensible. The statutory statement of General Duties to a large extent replaces the previous common law and equitable rules.

A director's primary duty to his company is now to act in a way which:

"he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole"

(section 172(1) of the Act).

Section 172(1) lists (non-exhaustively) the following "enlightened shareholder" value factors to which a director must have regard in order to fulfil this duty. These are:

likely long term consequences;

- employee interests;
- need to foster business relationships with suppliers customers and others;
- impact on the community and the environment;
- maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between shareholders.

The interests of creditors are not included (although employees, who may be creditors, are mentioned).

However, the duty to promote the success of the





company for the benefit of its members is expressed to have 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' (section 172(3)).

Potential for Confusion and/or Claims?

When a company is in trouble there are potentially conflicting duties: should the directors, when considering the interests of creditors also take into account the various factors set out in section 172(1), or are they only relevant when the directors are looking to promote the success of the company for the benefit of its members? There is no definition of "success" in the Act, although the Government has stated that for commercial companies "success" would normally mean "long-term increase in value".

For obvious reasons it is difficult to see what this should mean in the context of a company that has gone into formal insolvency.

The nature of directors' obligations in this area is not clear and has been left deliberately open by the draftsmen. In the Explanatory Note to the Act, it was stated that the purpose of the relevant proviso was to recognise that the duty to promote the success of the company is displaced when the company is insolvent but that, as regards the situation when a company is nearing insolvency, the intention was to "leave the law to develop in this area".

It is therefore suggested that the factors relevant to promoting the company's success under section 172(1) are not relevant at a time when the directors need to take the interests of creditors into account. Such factors are only required to be considered in solvent times when the directors are free to serve the interests of the company's shareholders. There appears to have been no intention to change the existing law governing how directors should exercise their duties when a company approaches insolvency.

As stated earlier, it is difficult for directors to know

precisely when creditors' interests are to take priority over the interests of shareholders (i.e. when the company is on the cusp of insolvency) as there is no neat dividing line.

There is clearly scope for future conflict where it is unclear to the directors whether they fall within section 172(1) or (3) territory, a consequence of the express inclusion in section 172(1) of those relevant matters is that concerns might be raised that the directors took them too much into account at a time when they should have been protecting the creditors' interests. Directors may find it more difficult to navigate the so-called "twilight zone" as a result.

Directors will require detailed advice as to whom their duties are owed in such circumstances and how best to discharge those duties and protect themselves from personal liability. The fact that the published guidance suggests that the application of the principle will be developed by the courts is almost an incitement to litigate the issue and is not exactly helpful.

IPs will need to consider the effect of the new provisions before taking enforcement action. There might also be an impact on Directors and Officers liability policies if increased litigation results.

By way of conclusion, the 2006 Act does not seek to clarify the common law rules about protecting the interests of creditors, it merely recognises and expressly preserves them. It therefore remains unclear at what point a director's duty to promote the success of the company for the benefit of its members is displaced by a duty to act in the interests of creditors, or even if it is possible for the two duties to exist in tandem.

There was and still is a "twilight zone". However, given the difficulty of creating a test capable of dealing with all possible situations, the decision to leave the common law in its current developing state provides no surprise.

Conclusion

Taking advice from a specialist is crucial at a time like this. Being able to demonstrate that timely specialist





advice was sought (and followed) will provide significant comfort and justification for the decisions that are taken.

A good practitioner will guide directors through this difficult time and with the benefit of experience be well placed to provide both the practical insolvency advice and legal expertise needed to give directors the support they require. As a result, the directors will receive peace of mind that they have done all that they can to justify their decisions and protect themselves from criticism, or even claims by an IP, in the future.

We live in a world of financial uncertainty and risk. We also live in an increasingly litigation focussed environment. Claim avoidance advice is a necessary defensive weapon for directors. In a negative financial climate creditors will encourage IPs to extend the lengths to which they are prepared to go to recover losses. The current creativity behind legal funding of claims against directors means restructuring advice and personal liability advice should not be postponed.

Directors should seek legal advice at a very early stage so as to help protect themselves. By doing so a lot of painful and unnecessary head-banging can be avoided.





→ Extracting Information from the Lehman Administrators



Brought into effect in less turbulent economic times, the corporate insolvency reforms introduced into the Insolvency Act 1986 by the Enterprise Act 2002 are now being stress tested in earnest.

A case in point is *Re Lehman Brothers International (Europe)* [1] which concerned the extent to which the administrators of LBIE, the European trading arm of the collapsed Wall Street investment bank, could be required by the court to provide information to individual clients or groups of clients about securities held by LBIE as pledged collateral for loans it had made to those clients on margin accounts.

The applicants were four hedge funds managed in the United States. These funds, in common with many others who were not party to the application, had been prime brokerage clients of Lehman at the time of its collapse.

Under their brokerage agreements, each had facility to borrow from Lehman on margin by pledging securities with LBIE as collateral. Of critical significance to the case, the agreements also permitted LBIE to reuse the client's securities in the market or as collateral for its own borrowings (a process often referred to as rehypothecation) [2].

The problem facing the administrators was that they needed to reconcile the positions on all of the brokerage accounts and identify securities held in the name of or to the order of LBIE that were unencumbered assets that should be returned to clients, a highly complex task.

The problem facing the funds was that their assets were trapped in LBIE which affected their ability to manage or sell those assets on behalf of their investors. The purpose of the application was to require the administrators to provide further information about the state of the applicants' securities than had hitherto been provided to enable them to decide how best to proceed in the interests of their investors.

The application was made principally under Sch B1, para 74(1)(b). This empowers a creditor of a company in administration to apply to court claiming that the administrator:

“proposes to act in a way which would unfairly harm the interests of the applicant (whether alone or in common with





some or all other members or creditors).”

If an application under para 74 is successful the court may grant relief in a variety of forms including an order requiring the administrator to do or not to do a specified thing.

The applicants contended that the administrator’s refusal to provide further information about their securities was unfairly harmful to their economic interests. Although not without sympathy for the plight of the funds, Blackburne J ruled that while their interests had clearly been harmed the administrators had not acted unfairly.

Information that was readily available to the administrators had been provided to all prime brokerage clients and arrangements put in place under the terms of an earlier court order for identifying and returning their assets. As far as the administrators were concerned there was no justification for expending resources on investigating the position in relation to the applicants’ securities which was not unique bearing in mind that LBIE had more than a thousand such clients whose assets were trapped [3].

The judge found no basis upon which he could interfere with the way the administrators had chosen to manage the affairs of LBIE pursuant to their statutory powers.

What is particularly helpful about Blackburne J’s ruling insofar as insolvency office holders are concerned is its clear signal that the concept of “unfair harm” must be understood in the light of the scheme of Sch B1 and the statutory duties and functions of the administrator.

The express purpose of the Lehman administration was to achieve a better result for creditors as a whole than would be likely if LBIE were wound up without first entering administration. The principal duty of the administrator under Sch B1, para 3(2) is to perform his functions in the interests of the company’s creditors as a whole.

On the evidence, as the administrators were seeking to carry out their functions in good faith in the interests

of all LBIE’s prime brokerage clients the judge found it impossible to conclude that they had acted unfairly by refusing to divert what they regarded as a disproportionate amount of time and resources to dealing with requests for information from one group of disgruntled clients [4].

In truth, the application looks as if it was too premature. The case provides a timely restatement of the principle that the courts should not lightly interfere with the exercise of the administrator’s statutory functions. As the recession deepens, adherence to this sensible principle will allow insolvency practitioners to get on with the job of dealing with the rising tide of corporate failures coming their way [5].

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Professor Adrian Walters

Geldards’ Professor of Corporate and Insolvency Law
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Professor Adrian Walters is one of the highest regarded academics in his field. He is the co-author of *Walters and Davis-White QC on ‘Directors’ Disqualification and Bankruptcy Restrictions*, the main practitioner text for that area of law. He lectures internationally on English insolvency and company law.

He contributes regularly to the major periodicals taken by insolvency lawyers. He is also a member of the editorial board for the periodical *Company Lawyer*.





Adrian leads the Insolvency and Corporate Law Research Group (ICLRG) at Nottingham Trent University's Centre for Legal Research, which forms part of the Nottingham Law School. The ICLRG focuses on research in consumer bankruptcy and corporate liquidation law, which includes corporate rescue.

Adrian's main interests are in the fields of corporate and insolvency law with increasing emphasis on consumer debt and insolvency and the regulation of the insolvency profession. He is currently engaged in research for the Insolvency Practices Council.

Adrian assists with on-going training at Geldards in a number of areas which overlap with insolvency including corporate, property and commercial contracts and will be speaking at a forthcoming Geldards Property Insolvency Conference on April 30 2009, for more info on this event please [click here](#).

[1] [2008] EWHC 2869 (Ch).

[2] [2008] EWHC 2869 (Ch) at [6], [20].

[3] [2008] EWHC 2869 (Ch) at [18].

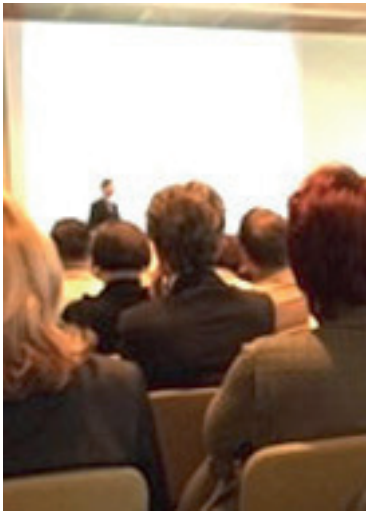
[4] [2008] EWHC 2869 (Ch) at [39].

[5] For a similar result see RAB Capital PLC v Lehman Brothers International (Europe) Ltd [2008] EWHC 2335 (Ch).





→ **Property Insolvency Conference 30 April 2009**



To book on this seminar click here

CPD 2 hours

Geldards is pleased to invite you to a free seminar, given by Professor Adrian Walters, the Geldards LLP Professor of Corporate and Insolvency Law at Nottingham Law School from 10:00am on Thursday 30th April.

The seminar is aimed at all business recovery and insolvency professionals and funders. The seminar will cover the treatment of claims for rent in insolvency proceedings but focuses primarily on recent developments in corporate insolvency law relating to administration and company voluntary arrangements.

This event will also provide an opportunity to share ideas and thoughts with other professionals and there is an optional networking lunch after the seminar which will be attended by landlord and tenant surveyors, plant and machinery and asset valuers, estate managers as well as property owners and funders.

The programme will include:

- The treatment of claims for rent in insolvency proceedings
- The impact of the moratorium in administration on landlords' rights
- Recent cases: ***Metro Nominees v Rayment*** and ***Innovate Logistics v Sunberry Properties***
- The impact of company voluntary arrangements on landlords' rights
- Surrender and statutory disclaimer of leases
- The impact of insolvency proceedings on third party guarantees of tenant obligations





Timetable

Registration & Coffee 10:00am

Welcome & Introductions 10:30am

Professor Adrian Walters 10:40am
Geldards Professor of
Corporate and Insolvency Law

Closing Remarks 12:20pm

The conference will be followed by lunch.

CPD 2 hours

To book on this seminar click here

