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May 2020

# VIRAL LAW

A blog series on legal issues arising from the *Corona* pandemic

## Duties of Directors towards a company in financial distress

by

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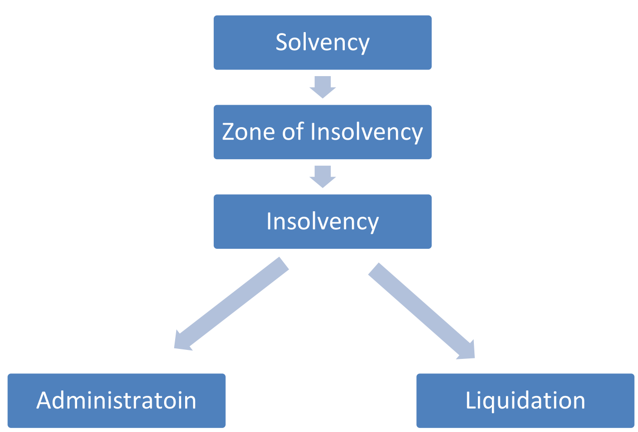
**DUTIES OF DIRECTORS TOWARDS A COMPANY IN FINANCIAL DISTRESS**

## Introduction

Even very successful enterprises can fall into severe financial distress when the overall economy of a country falls apart due to a crisis like the Covid-19 pandemic. In such a situation, the directors of a company must act prudently to take the right decisions at the right time. The duties of directors are set out in the Companies Act, No. 07 of 2007 (hereinafter referred to as the '**CASL**'). Although legislators have taken extra effort to codify the duties of directors when drafting the CASL, they failed to give enough clarity in relation to how such duties should be carried out when a company is in financial distress. Therefore, directors are cautioned to exercise extra care during such times as a failure to do so may result in them being held personally liable.

## Different Levels of Insolvency

A company does not become insolvent overnight. It is a gradual process. Even if the CASL does not expressly provide so, it is clear that the act recognizes five different legal statuses corresponding to different levels of financial condition, i.e. there is recognition of differing stages of insolvency in respect of a company that is experiencing financial deterioration. These are: solvency (non-insolvency), the zone of insolvency, insolvency, liquidation and administration. As such, a company that transitions from solvency to insolvency due to financial deterioration, may experience the following legal statuses:



The stages of solvency and insolvency are easy to identify based on the company's financials. The stages of liquidation and administration arise out of an express declaration / determination to the effect that the company is at such stage. Therefore, they are also easy to identify. However, the term 'zone of insolvency' is not expressly used in the CASL. It is a concept of law identified under English Law. Nevertheless, even without express reference, there are certain provisions in the CASL which resemble the applicability of the concept.[1] The application of this concept also could be considered under Section 3 of the Civil Law Ordinance. The significance of identifying this as a separate level of insolvency is that the actions taken by the directors during this stage would be a determining factor when deciding if such directors have executed their duties correctly as owed at or during a particular period of time.

The term 'zone of insolvency' refers to the interim stage of near insolvency, when a company is in financial distress but may or may not go into insolvency. There are various methods of identifying if a company is in the zone of insolvency. The following is a simple test which can be used to determine this:

> *Will the company be unable to pay its debts when they fall due after a transaction or series of transactions is authorized by the board or a decision is taken by the board of directors?*

If the above question is answered in the affirmative, then the company is in the zone of insolvency. In fact, many companies which are in financial distress today may fall into this category.

Each of these differing levels of insolvency subject directors to varying legal rights and obligations. At some stages, the directors owe their duty to the company (and eventually to shareholders) whilst at some stages the company owes its duty to the creditors. Therefore, directors should pay extra attention with regard to the nature of their duties and to whom they owe such duties at each level of insolvency.

[1] Sections 57, 401 (1) (a) and 248 (1) of the CASL

## A. Duties of Directors at the Stage of Solvency

If a company can satisfy the Solvency Test,[2] it is considered as a company in the Stage of Solvency. This is, by and large, the stage at which most companies were prior to COVID -19. In general, the Board of Directors has full power to govern the business and affairs of a company[3] during this time. Such powers must be exercised subject to the general duties owed by each and every director to their respective companies – including, for example, the duty to act in good faith and in the best interests of company[4], the duty to act according to the articles[5], the duty of (standard of) care[6], the duty to use information and advice[7], the duty to avoid conflicts of interest[8] and to make disclosures[9], which are some of the most common statutory duties owed during this time.

Notably, all the aforesaid duties are owed to the company. Therefore, it could be stated that while the company is solvent, the directors' duties are towards the company. The interest of the company includes the interests of its constituents - including its shareholders, employees and creditors[10]. Under the CASL there is no provision where the stakeholders of the company, other than the shareholders, can bring an action against directors for a breach of duty where the company is solvent and has not gone into liquidation.[11] Therefore, when exercising their duty toward the company while it is solvent, directors should focus on the interest of the shareholders as opposed to creditors. Hence, the best interest of a solvent company is, broadly, to continue the company's business and enhance its wealth and value, to the benefit of its stakeholders.[12]

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[2] Under Section 57 of the CASL
[3] Section 184 of the CASL
[4] Section 187 of the CASL
[5] Section 188 of the CASL
[6] Section 189 of the CASL
[7] Section 190 of the CASL
[8] Section 193 of the CASL
[9] Section 192 of the CASL
[10] L.V.V Lyer, Guide to Company Directors Powers, Rights, Duties, Liabilities & Corporate Social Responsibilities, 3rd Ed, 2011,Lexis Nexis at p. 251
[11] Section 376, 375 of the CASL
[12] P. L. Davies ,Gower and Davies' Principles of Modern Company Law, 8th Ed, 2008, London, pp. 365 – 366 .

## B. Duties of directors whilst in the Zone of Insolvency

If a company is in the zone of insolvency, the directors should carefully evaluate the facts and decide if they should move forward with the business or initiate other processes such as liquidation, administration or compromise. If the directors prioritize the company's / shareholders' interests, then they can choose the first option and continue with the business or, alternatively, decide to initiate the process of administration. However, if they prioritize the creditors' interests, they should choose to begin processes such as liquidation or compromise with creditors.[13] The critical question would be the point at which the directors should shift their focus relating to whom their duties are owed. If a wrong choice is made, the shareholders or creditors could subsequently sue the directors, depending on who suffers the loss. Unfortunately, there are no express provisions in the CASL to guide directors as to whom they owe their duties to once the company is in the "zone of insolvency" stage. It is therefore solely a decision that the directors must make depending on the circumstances at hand. Once the decision is made, there is always a risk that the directors could be sued by the creditors or the shareholders depending on the outcome.

### a) Position under English Law

English Law favours the position that when a company is in the zone of insolvency, the directors should consider the interest of the creditors. For example, in *the Liquidator of Wendy Fair (Heritage) Ltd v Hobday*,[14] the Court held that when a company is 'nearing insolvency' the directors have a duty to consider the interest of the company's creditors.[15] Likewise, Courts in the United Kingdom have held that directors should consider the interests of a company's creditors when the company is 'on the borderline of insolvency' *[16]* and, correspondingly, that liability can accrue to such creditors where such company is 'on the verge of insolvency'.[17] Notably, the explanations of the Court in some instances are not even confined to express references to solvency

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[13] Under Section 248 of the CASL

[14] [2006] EWHC 5803

[15] See also - Kinsela v. Russell Kinsela Pty Ltd. [1986] 4 ACLC 215 at 223 ; Winkworth v. Edward Baron Development Ltd [1986] 1 WLR 1512 – which consider whether the duty of directors towards its creditors arises where the company is 'of doubtful solvency'.

[16] Eastford Limited v. Gillespie, Airdrie North Limited [2010] CSOH 132

[17] Gwyer v. London Wharf (Limehouse) Ltd. [2002] EWHC 2748 (Ch); [2003] BCC 885;

or insolvency at all. In such cases, the Court arrived at a determination directly based on the financial status of the company. For instance, there are cases where the Courts have used terms such as a 'dangerous financial position[18]', 'in a parlous financial state[19]', or 'in financial difficulties'[20] for identifying the stage at which directors should reconsider to whom they owe their duties to as directors. Therefore, in summary, the cases referred to above clearly highlight the fact that when the company is in the zone of insolvency, under UK law, the directors owe their duty towards the creditors of the company.

These cases also demonstrate that the question of whether and when the duties of a director shift in favour of creditors has to be decided on the facts at hand. The court has not been inclined to set strict guidelines on when and where there should be a shift in a director's focus as to whom he owes his duties. In fact, in *Linton v. Telnet Pty Ltd,*[21] the New South Wales Court of Appeal in Australia similarly stated that the issue of when the directors should shift their interest would depend on the facts. Therefore, the exact point of transference within the zone of insolvency is still a question of fact which has to be determined by courts on a case by case basis.

### b) Position under US Law

Unlike in the UK, the applicable law in the United States depends on the standards and thresholds recognized by the laws of each state. Broadly, however, whilst in the zone of insolvency, the directors and officers of the company continue to have duties to the company and its shareholders under US Law. [22] However, in addition to such duties, when a company is perceived to be on the verge of insolvency, its directors and officers become fiduciaries of the corporate assets of the company for the benefit of its creditors.[23] In *Credit Lyonnais,*[24] the US courts recognized for the first time that individual directors of financially distressed companies operating in the zone of

[18] FaciaFooware Ltd (in administration) v. Hinchliffe 1 BCLC 218 at 228
[19] Williams v. Farrows [2008] EWHC 3663 (Ch)
[20] Re MDA Investment Management Ltd [2003] EWHC 227 (Ch) 42; [2005] BCC 783
[21] [1999] NSWCA 33; [1999] 30 ACSR 465
[22] *John, AP &Ilya AL 2011,'The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency', ABI Law Review, Vol.19, pp. 361 – 399 at* p 373
[23]*Id.*
[24]*Credit Lyonnais Bank Credit Lyonnais Bank Nederland, N.V. v. Pathe Communication Corp*. C.A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991)

insolvency owe a duty to a "community of interests", including creditors. In *Gladstone v. Stuart Cinemas Inc*,[25] the Court stated that this duty to creditors does not only apply when a company is insolvent, but also when the company operates in the vicinity or "zone of insolvency". In *3 Point Holdings L.L.C v. Gulf South Solutions, L.L.C*,[26] the Court stated that when directors and officers operate in the zone of insolvency, their fiduciary duties include duties towards the creditors of the company. Moreover, there are a series of judgments in the US which state that in 'the zone of insolvency the directors of the company should exercise a duty of care, duty of loyalty and a duty to act in good faith'.[27]

It is to be noted, however, that in the US, judges, in examining the amount and scope of the duty owed to creditors by the directors,[28] have stated that although directors are required to consider the interests of creditors whilst in the zone of insolvency, this does not necessarily give their interests priority.[29]

### c) Position in Sri Lanka

The Sri Lankan position on this point remains unresolved both under the CASL as well as in case law. However, considering the fact that the application of Section 219 of the CASL at least requires cash flow insolvency,[30] it could be contended that, in the zone of insolvency, the CASL favours the position that directors would continue to owe their duties to the company / shareholders instead of to its creditors. This position could be further supported by the fact that, even in the liquidation process, creditors can file action against the directors only for fraudulent conduct and not for the breach of any duty towards the protection of the interests of creditors.[31]

[25] 878 A. 2d 214 (Vt. 2005)
[26] No. 06-10902,2008 WL 695379 (E.D. La. Mar. 13, 2008)
[27] *John, AP &Ilya AL 2011,'The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency', ABI Law Review, Vol.19, pp. 361 – 399* at p 374
[28] *id*, at pp. 371 - 378
[29] *id*, at p. 374; *In reBerg*, 178 Cal App. 4th 1038
[30] Company cannot pay its debt when it falls due
[31] Section 374 and 375 of the CASL

Nevertheless, the bottom-line is that there is no clear position under the CASL upon which a director can rely on. Therefore, directors should address the issue based on the facts of each respective case.

## C. Duties of Directors when a Company is in Insolvency

Sections 219 and 220 of the CASL impose two very specific duties on directors when exercising their powers and carrying out business in a situation where a company is in financial distress.

Section 219 provides that if the company cannot pay its debts as they fall due, the directors should forthwith call a meeting of the board to consider whether the board should apply to court for the winding up of the company and the appointment of a liquidator / administrator or continue to carry on the business of the company.

Similarly, Section 220 provides that if at any time it appears to a director of the company that the net assets of the company are less than half of its stated capital, the board must call an extraordinary general meeting of shareholders of the company. At such extraordinary general meeting, the board must present a report with regard to the nature of the losses of the company and the remedial actions that are being taken by the board in order to prevent further such losses or to recoup the losses incurred. Correspondingly, the shareholders have the right to discuss the report and question the board thereon.

### a) Personal Liability of a Director for the Losses of the Company

It should be noted that both Sections 219 and 220 impose an obligation on directors to make a voluntary and personal estimate on the financial status of the company without delay. A director does not have to wait until such deteriorated financial status of the company is brought to the attention of the board by the auditors or finance department of the company.

If a director fails to carry out his duty as set out above, such a director would be personally liable. If a director fails to call a meeting of the board of directors under Section 219 (1), and if the company is subsequently placed in liquidation, such director will be liable to the liquidator or the creditors in relation to all losses incurred by the company by continuing to carry on its business. Similarly, when the meeting of the board is called, if the director makes a wrong choice – then, in such instances, the director will also be personally liable for the losses incurred by the company by continuing to carry on its business. On the other hand, if a director fails to fulfil the duties under Section 220 with regard to a serious loss of capital, the director will be guilty of an offence.

**b) When should the duties be exercised?**

The duties under Sections 219 and 220 must be exercised with a high degree of care and caution. Moreover, it should not be exercised in conflict with other duties imposed upon directors. If a director exercises one of these duties by calling a meeting at the wrong instance, it could cause more damage to the company than good. For example, one could imagine what the consequences would be if a director of a finance company were to call such a meeting when the company was in a recoverable financial position. Such a wrong decision could even result in an action against such director by the company or the shareholders instead of the creditors. Therefore, in making such a decision, a director must balance the conflicting interests between the company, its shareholders, and creditors.

Similarly, even if Section 219 seems very simple to abide by, this isn't necessarily the case. Firstly, a director should decide when he should call the board meeting. Practically, not every director of a company would have and maintain ready access to, or knowledge of, the current financial status of the company. Therefore, depending on the facts of each case, the obligation to call the meeting may not necessarily arise in respect of all directors at the same time. Secondly, once the meeting is called, a director has three choices, i.e. to liquidate the company, initiate the administration process, or to continue the business. This is a critical choice. When making this decision, the director should evaluate the facts available based on the level of insolvency of the company and consider to whom he owes a duty at that specific stage. If the facts favour the position that the directors should maintain their duty towards the company, the logical option would be to decide in favour of the continuation of the business or initiation of the process of administration. However, if the directors consider that their duty is to the creditors, they should instead choose liquidation.

## D. Duties of directors during the process of administration

Directors have a discretion[32] in deciding whether or not to proceed with the process of administration. When exercising such discretion, it is the duty of the director to consider if there are sufficient grounds to appoint an administrator. If the directors appoint an administrator when there are no actual grounds to do so, the shareholders may bring a derivative action against such directors. Therefore, it is submitted that, at the point of making the decision, the directors owe their duties to the shareholders of the company.

## E. Duties of directors during the process of liquidation

A company can be wound up if it "is unable to pay its debts"[33]. The phrase "unable to pay its debts", as applicable to the context of liquidation, is defined[34] in the CASL. After the winding up process commences, the duty of the directors is to realize and preserve the assets of the company for distribution. Winding up of a company may commence either when the company is solvent or when the company is insolvent. In both instances, the directors must consider the interests of the creditors in exercising their powers during the winding up process.[35] However, in relation to shareholders, this position is different. If the process commences when the company is solvent, then the directors must consider the interests of the shareholders during the process of winding up. Furthermore, if the winding up of the company commences during a period where the company "is unable to pay its debts", then the directors may or may not be required to consider the interests of the company's shareholders.

Therefore, as a general rule, it is suggested that, in the process of winding up, whether the directors have a duty to the shareholders or not depends on the question of whether there will be any surplus of assets remaining for distribution amongst the shareholders after satisfying all the other claims. If the answer is affirmative, then the directors owe a duty to the shareholders during the process of

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[32] Section 401 of the CASL
[33] Section 270 (e) of the CASL
[34] Section 271 of the CASL
[35] Section 374, 375 and 376 of the CASL support this position

winding up. If there will be no surplus remaining, then the directors will only owe their duty to the creditors.

It should be noted that, under Sri Lankan Law, if the company is in the course of winding up – then, in addition to the creditors and liquidators, the shareholders have a right to institute an action against any director who has misapplied, or retained or become liable or accountable for money or property of the company, or who has been guilty of negligence, default or breach of duty or trust in relation to the company.[36] The courts have authority, in such a situation, to order the directors to make a contribution to the assets of the company as compensation.[37] Therefore, this section indicates that, even if the directors do not owe a duty to the shareholders during the period of insolvency, the shareholders may still bring an action against them for breach of duty in relation to the company on the specific grounds stated above. Accordingly, given that such action can be brought against "*present directors…….being guilty of breach of duty… in relation to the company…*", it is suggested that the rights of shareholders do extend to the breach of duty in relation to the company during the process of winding up.

**Conclusion**

Directors should, at all times, exercise their powers prudently and subject to the duties they owe. As demonstrated above, these obligations vary depending on the level or stage of insolvency of the company. Therefore, when a company is in financial distress, its directors must carefully exercise their powers by giving due attention to the particular stage or level of insolvency being faced. This is essential – given that a failure to do so may result in such directors being held personally liable for the ensuing losses or being convicted of an offence.

[36] Section 376 (1) of the CASL
[37] Section 376 (1) b (ii) the CASL