

### WELCOME

In this August 2008 edition of the Corporate & Commercial Bulletin we will highlight directors responsibilities should their company become insolvent and sound a note of caution in respect of the position of shadow directors.

We hope you find this bulletin of interest and, as always, if you have any queries on this or any other Corporate & Commercial matter please do not hesitate to contact a member of our Corporate & Commercial team.

### Directors' responsibilities should their company become insolvent

- David Naughton

#### Introduction

With the ongoing credit crunch impacting on Irish businesses, directors must be vigilant against the risk of restriction or disqualification if their company should become insolvent.

#### Restriction from acting as a director

If an insolvent company is wound up a director may be restricted from acting as a director or the secretary of any other company for a period of five years unless that other company has a paid up share capital of just under €3,500. Whilst €3,500 may seem a small amount, the negative publicity attached to a restriction order is worth avoiding.

The key questions a director should bear in mind in running his company to avoid a restriction order include:

1. Have I complied with the obligations imposed on me by the Companies Acts?
2. Could my conduct be regarded as so incompetent as to amount to irresponsibility?
3. To what extent have I been responsible for the insolvency of the company?

4. To what extent have I been responsible for the net deficiency in the assets of the company disclosed at the date of the winding up or thereafter?; and,
5. In my conduct of the affairs of the company, have I displayed a lack of commercial probity or want of proper standards?

#### Disqualification from acting as a director

Section 160(1) of the Companies Act 1990 provides for automatic disqualification from acting as a director where a person is convicted on indictment of any indictable offence in relation to a company involving fraud or dishonesty, for a period of five years or such other period as the court may order.

#### Matters which may give rise to restriction, disqualification and personal liability for debts of the Company

In insolvency the matters which will most often arise for consideration are:

- alleged reckless trading;
- alleged fraudulent trading;
- alleged failure to keep proper books of account of the company;
- alleged fraudulent preference of a creditor.

#### Reckless trading

The test for a director to consider is whether he is carrying on the business in a manner which the director knows involves an obvious and serious risk of loss or damage to others yet ignores that risk because he does not care whether others suffer loss or damage or because his selfish desire to keep his company alive overrides any concern for others.

The following may be useful pointers to assist directors in avoiding an allegation of reckless trading:

1. Review weekly financial reporting carefully; and
2. Fully consider the proposal to incur liabilities during difficult trading periods, paying

particular attention to a review of the assets and liabilities of the company and the cash flow of the company in making this decision.

### **Fraudulent trading**

The issue here is whether the director was knowingly a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose. Examples of fraudulent trading include failure to make payments into an employee pension scheme, tax evasion and incurring credit at a time when, to the knowledge of the director, there is no prospect of that credit being repayable.

It is not always easy to succeed in making a director liable for fraudulent trading because of the difficulty of proving intent.

### **Necessity to keep proper books of account**

The Companies Acts have expressly made clear that an officer can be held criminally liable for failure to keep proper books of account and also have personal liability for the debts and obligations of the company. Keep on top of the paperwork!

### **Fraudulent preference**

Fraudulent preference is the wrongful favouring of one creditor over others. Any such activity undertaken by a company which is unable to pay its debts is deemed to be a fraudulent preference and is invalid. An example of a payment which a liquidator is likely to closely examine is a repayment of borrowings where the director has given a personal guarantee of those borrowings and will be personally liable if the company should fail.

### **Summary**

In the current climate, directors should be in receipt of comprehensive and timely information about the affairs of the company and continue to keep its performance under review. It would also be advisable to ensure that board meetings are properly convened, held and minuted and that the directors seek professional advice in advance of any significant decisions.

**Shadow Directors – a note of caution**  
- JP Gilmartin

A shadow director is a person who is neither formally appointed, nor necessarily held out as a

director of a company, but to whom certain sanctions and regulations, normally reserved for directors, can be applicable.

Section 27 of the Companies Act 1990 (the “**1990 Act**”) defines a shadow director as:

“...a person in accordance with whose directions or instructions the directors of a company are accustomed to act ..... unless the directors are accustomed so to act by reason only that they do so on advice given by him in a professional capacity.”

The implications for a person found to be acting in the role of a shadow director of a company can be far reaching and onerous and include: -

- exposure to disqualification and restriction orders;
- potential liability for reckless trading in the event of an examinership or the winding up of a company; and
- restrictions on many property and financial related transactions between a shadow director (to include any person connected with such a shadow director) and the company to which that person is a shadow director.

### **The Professional Advice Exception**

The professional advice exception means that a person, who gives directions or instructions to directors of a company on foot of which they are accustomed to act, but only by way of professional advice given in a professional capacity, will not be deemed to be a shadow director, for example advice given by an accountant or lawyer acting as such. A professional advisor does not direct or instruct a company on what it should do but simply advises the company on what in his professional judgment is the best course of action.

### **How to establish a person is a shadow director?**

To establish that a person is a shadow director of a company it is necessary to allege and prove:

- who are the directors of the company;
- that the person directed *and instructed* those directors how to act in relation to the company or that he was one of those persons who did so;
- that those directors acted in accordance with such directions; and
- that they were accustomed so to act.

## Who are the directors?

De facto directors are persons ‘*occupying the position of director*’ but who have not been formally appointed. On the other hand, de jure directors are persons ‘*occupying the position of director*’ who have been formally appointed as directors in accordance with applicable laws.

## Directed or Instructed

The real directors of a company must act in accordance with the ‘*directions or instructions*’ of the shadow director. In **Re Unisoft Group Limited**<sup>1</sup> it was held that “*the shadow director must be, in effect, the puppet master controlling the actions of the Board*”.

## Acted in Accordance with such Directions or Instructions

A person will not be deemed to be a shadow director, even if he or she makes directions or instructions, if the real directors do not, in fact, act in accordance with such directions or instructions.

## Were Accustomed so to Act

It is envisaged that the actual directors of a company must not only act on the directions or instructions of a shadow director, but must be “accustomed so to act”. The plain meaning is that the shadow director must have issued more than one direction or instruction that was acted upon or in other words there must be a pattern.

## Can Bodies Corporate be Shadow Directors?

Under Irish company law, a body corporate may not be a director of an Irish company. However the High Court in **Worldport Ireland Limited (in liquidation)**<sup>2</sup> held that a company, and not merely a human person, may be a “shadow director” of another company.

In that case the court held that a body corporate (whether incorporated in Ireland or elsewhere) could be a shadow director both generally and for the purpose of director restriction proceedings.

## Bank Deemed to be a Shadow Director

In the case of **Ex p Copp**<sup>3</sup> the question of whether a bank could be deemed a shadow director arose in the

context of wrongful trading under English law (the equivalent to reckless trading under Irish law). When the company concerned exceeded its overdraft, the lending bank sought and obtained a fixed charge on the company’s book and other debts in furtherance of a bank commissioned report.

The company went into liquidation and the liquidator to the company, amongst other things, sought an order to the effect that the bank concerned was a shadow director of the company and had traded wrongfully. One of the grounds relied upon by the liquidator was that, at an early stage, the bank was aware that the company was insolvent with no reasonable prospect of avoiding insolvent liquidation. On the facts, Knox J. held that the claim against the bank was sustainable, and that it was possible that the bank may have been a shadow director.

## CONCLUSION

The consequences of an individual or a body corporate being deemed to be a shadow director could, as highlighted above, be far reaching. In this challenging economic environment it will be necessary for bodies corporate and individuals who may seek to influence the affairs of companies to be mindful of the implications of their role extending to that of a shadow director. With insolvent liquidations gathering momentum, appointed liquidators will analyse carefully the extent to which individuals and corporate bodies assume the role of ‘*puppet master*’ when controlling the actions of the boards of insolvent companies and may seek to hold such persons or corporate bodies to account as shadow directors.

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<sup>1</sup> Re Hydrodam (Corby Limited) [1994] 2 BCLC 180

<sup>2</sup> (Mr Justice O’Leary, 16 February 2005)

<sup>3</sup> Ex p Copp (1989) BCLC 12; Re a Company (No. 005009 of 1987)