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Covid-19 and Directors' Duties: Navigating the way forward for your company in times of financial stress

With the current COVID-19 lockdown and likely recession to follow, many companies' businesses will come under significant financial stress, with cash flow and the ability to pay creditors severely impacted.

The Companies Act 1993 (Act) imposes certain duties on directors to protect creditors and it is therefore crucial that directors understand their duties in this time of financial stress to avoid personal liability.

Reckless trading

In particular, directors need to be aware of their obligations in relation to reckless trading under section 135 of the Act. Section 135 prohibits directors from agreeing to, or causing or allowing, the business to be "*carried on in a manner likely to create a substantial risk of serious loss to the company's creditors*". This duty requires company directors to consider the risk of loss to company creditors when faced with solvency issues. The Court will apply an objective test and it is not what the director believed that is the focus, but rather what a prudent director should do once a company becomes insolvent. A sober assessment is required of the company's prospects and risk to creditors. If directors are found to be in breach of this duty, they can be held personally liable for some or all the company's post liquidation losses to creditors.

On application by a liquidator, creditor or shareholder, the directors can be ordered under section 301 to pay compensation in an amount that the Court thinks is just. The starting point is to determine the point in time that the directors knew or should have known when the company should have ceased trading because continued trading was likely to create substantial risk of serious loss to creditors. The increase in the loss to creditors from that point in time to liquidation is then calculated. For example, if the total loss on liquidation in December 2020 is $1 million and the company owes creditor $200,000 at the point it should have ceased trading, then the amount that directors may face liability for is $800,000. This amount is then adjusted by the Court taking into account the length of insolvent trading, the directors' conduct and their link to the loss.

The simple fact that a company is insolvent does not necessarily mean the directors must cease trading. The position may be temporary and recoverable or there may be legitimate steps that the directors can take without a substantial risk of serious loss to creditors. For example, the court in Cooper v Debut Homes (in liq) [2019] NZCA 39 held that the completion and sale of houses that the company had been building was a sensible decision by the director and likely improved the position of creditors. In addition, the court will give weight to the words "likely" and "substantial". Continued trading must be likely to cause loss and that loss must be substantial. The possibility of a small loss is not enough.

Duty in Relation to Obligations

In addition, to section 135, section 136 provides that "*a director must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so*". This duty captures the situation where, for example, a company enters into a contract for the purchase of land and does not have the finance in place and subsequently cannot source finance and complete. Additional care will need to be taken in the current environment when entering into contracts to make sure the company has the funds and finance to complete.

Safe Harbour

The Government, recognising the extraordinary situation created by Covid-19 and the difficulties faced by directors in complying with their duties under sections 135 and 136, has announced a temporary

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"safe harbour" in respect of breaches of these two sections.

For the next six months, directors who continue to trade their companies, which includes taking on new obligations, will have a "safe harbour" from potential claims under sections 135 ("Reckless Trading") and 136 ("Duty in Relation to Obligations") of the Act provided that:

- in their opinion, acting in good faith, the company is likely to face significant liquidity problems in the next six months as a result of Covid-19;
- the company was able to pay its debts as they fell due at 31 December 2019; and
- in their opinion, acting in good faith, it is more likely than not that the company will be able to pay its debts as they fall due within 18 months. This may be as a result of improved trading conditions or their genuine belief that they will be able to reach an accommodation with their creditors.

The legislation has not been enacted yet as the Government is in lock down, but will be backdated to the commencement of the lockdown once passed. The purpose of the provision is to assist otherwise viable companies by giving them the freedom and protection to make difficult decisions in good faith. However, it is not a free pass and if the company was already struggling and could not pay its debts prior to the crisis (i.e. 31 December 2019) or the company is unlikely to recover, the safe harbour will not apply. It will be important for directors to get advice so assist them in determining whether safe harbour applies.

How to mitigate the risks?

Regardless of whether the safe harbour applies there are a number of steps a prudent director should be taking to mitigate the risk of liability that courts have commented on and include the following (please note that these steps are not exhaustive):

- ensuring that management have the tools and accounting systems to provide timely and accurate financial information on the company, including cash flow, debtors and creditors;
- regular communication with the company's bankers;
- obtaining appropriate financial and legal advice from accountants and lawyers including in particular the applicability of the safe harbour;
- ensuring that all inter-company assurances upon which directors rely are in writing, legally binding and are of substance;
- all minutes and other company records are properly kept;
- ongoing assessment of the company's likely future income and prospects;
- deferring payment of dividends or repayment of current accounts to shareholders; and
- ensuring that the company does not enter into an obligation that it does not have the funds perform and in particular ensuring that is funding lines are secure.

Obtaining proper legal and accounting advice can, in certain circumstances, provide a defence for directors, provided the advice is followed and it is reasonable to rely on that advice.

Want to know more?

If you have any questions with regards to the above article, please contact our insolvency and restructuring team.