



Investor Directors of Distressed Companies: How Should They Act?

. . . .

INTRODUCTION

For most private equity and venture capital firms, it is an established industry practice to appoint their partner(s) to act as investor director(s) in their portfolio companies with a view to gaining more active supervision and management of the company. Few, if any, questions have been asked, and scant concerns have been raised about this standard practice during the recent golden era of finance. After all, most companies performed well, and in good times there is rare occasion to question the performance and prudence of the directors. However, the current financial turmoil is casting doubt on this standard practice. Irrespective of how or why a director holds office, he or she still has certain duties and responsibilities.

A crucial question facing all directors who sit on boards of UK companies in troubled market conditions is the following: what can they do to keep the company in business without running the risk of committing an offence or incurring a personal liability? Investor directors must ask themselves the same question because they also owe a duty to the company.

POTENTIAL FOR PERSONAL LIABILITY

Directors of private UK companies who have fallen on hard times may find themselves at risk of participating in the following actions¹ before a company becomes subject to an insolvency proceeding for which they will be liable:

1. Wrongful Trading²

The court may require that a director contributes to a company's assets, where the company has gone into insolvent liquidation and that director knew or should have known that the company could not reasonably avoid insolvency.

Wrongful trading is a difficult problem for directors because of the imprecision in determining that they had taken every step to minimise potential loss. Therefore, it is highly recommended that directors seek legal advice early and act upon it promptly.

2. Fraudulent Trading³

Where a person who was knowingly a party to the conduct of business with intent to defraud creditors of the company or for any other fraudulent purpose, a liquidator can apply to the court to declare that that person is liable to make a contribution to the company's assets.

A person found guilty of Fraudulent Trading may also have a disqualification order made against him or her by the court.⁴

Boston

One Financial Center
Boston, MA 02111
+1.617.856.8200
+1.617.856.8201 [fax]

New York

Seven Times Square
New York, NY 10036
+1.212.209.4800
+1.212.209.4801 [fax]

Hartford

City Place I
185 Asylum Street
Hartford, CT 06103
+1.860.509.6500
+1.860.509.6501 [fax]

Providence

121 South Main Street
Providence, RI 02903
+1.401.276.2600
+1.401.276.2601 [fax]

London

8 Clifford Street
London, W1S 2LQ
United Kingdom
+44.20.7851.6000
+44.20.7851.6100 [fax]

Washington, D.C.

601 Thirteenth Street NW
Suite 600
Washington, DC 20005
+1.202.536.1700
+1.202.347.4242 [fax]

Dublin

Alexandra House
The Sweepstakes
Ballsbridge, Dublin 4
Ireland
+353.1.664.1738
+353.1.664.1838 [fax]

www.brownrudnick.com

Brown Rudnick LLP is a Limited Liability Partnership ("LLP") regulated by the Solicitors Regulations Authority and registered in England & Wales, No. OC300611. We use the word "partner" to refer to a member of the LLP, or to an employee or consultant with equivalent standing and qualifications. A full list of members, who are either solicitors or registered foreign lawyers, is open to inspection at the registered office, 8 Clifford Street London W1S 2LQ.

Information contained in this Alert is not intended to constitute legal advice by the author or the attorneys at Brown Rudnick LLP, and they expressly disclaim any such interpretation by any party. Specific legal advice depends on the facts of each situation and may vary from situation to situation.

Distribution of this Alert to interested parties does not establish an attorney-client relationship. The views expressed herein are solely the views of the authors and do not represent the views of Brown Rudnick LLP, those parties represented by the authors, or those parties represented by Brown Rudnick LLP.



3. Misfeasance or Breach of Fiduciary Duty ⁵

Where a director has misapplied/retained/become accountable for company assets, or been guilty of any misfeasance or breach of any fiduciary or other duties, the court may order the director to repay/restore/account for the assets.

4. Other Offences and Common Law Duties

There are additional offences under the Insolvency Act 1986 such as transactions in fraud of creditors⁶, defrauding creditors⁷, misconduct in the course of winding up⁸ and false representations to creditors.⁹

Common law duties also apply, and directors owe a duty to the company to act in the best interests of the creditors of the company.¹⁰

CONCLUSION

Given the current financial climate, it is prudent for directors to be more proactive and cautious than usual. This might mean that a company's board has to seek independent advice separate from the advice obtained by the company in order to be properly protected. As soon as the directors are aware that their company is in financial difficulty, they should seek external advice (a step endorsed by the Department of Trade and Industry - now the Department for Business Enterprise and Regulatory Reform).

¹ Pursuant to the Insolvency Act 1986 (the "Act")

² s214 of the Act

³ s213 of the Act. Fraudulent trading is also a criminal offence under s993 of the Companies Act 2006.

⁴ s10 of the Company Director Disqualification Act 1986

⁵ s212 of the Act

⁶ s207 of the Act

⁷ s423 of the Act

⁸ s208 of the Act

⁹ s211 of the Act

¹⁰ as preserved by s172(3) of the Companies Act 2006

For more information please contact the following Partners based in Brown Rudnick's London office:

James Shaw

+44.20.7851.6078

jshaw@brownrudnick.com

Louise Verrill

+44.20.7851.6072

lverrill@brownrudnick.com

Brown Rudnick is an international law firm with offices in the US and Europe. Our 200 attorneys provide assistance across key areas of the law, including complex litigation and arbitration, bankruptcy and finance, corporate and securities, intellectual property, real estate, energy, and government law and strategies.