

INSIGHT: BOARD EXPERTISE

How to navigate financial difficulties



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A focus on governance and getting the right advice can help steer the board through financial uncertainty and mitigate potential liability.



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SAVE

Several recent judgments have developed the law on directors' duties—and their potential liability for losses—in the event that a company enters an insolvency procedure, with directors being found liable for millions of pounds of company losses.

With **certain sectors remaining under pressure**, your business (or suppliers/customers) may well encounter potential financial difficulties at some stage in the future. This article outlines how to identify early warning signs and recommends certain practical steps to protect the business and the directors from personal liability in the case of headwinds.

Early warning signs

Recognising potential financial difficulty early on and acting promptly improves the likelihood of successfully addressing it. Early warning signs will differ across industries, but often consist of some of the following:

- limited headroom under (or anticipated breach of) financial covenants and/or uncertainty around refinancing of upcoming debt maturities;
- declining sales, cash flow or revenue (outside usual seasonal swings) leading to reduced cash reserves or increased reliance on revolving facilities;
- supply-side issues (such as supply delays, increased costs, shorter payment terms, uncertainty around supply contract extensions or insolvency of suppliers);
- buy-side issues (for example, decreased demand, delayed payments, uncertainty around purchase contract extensions or insolvency of customers);
- material change in legislative framework (for example, tax, regulatory, trade or safety standards) affecting the business or its suppliers/customers; and/or
- one-off events (such as forced closure of a critical production facility, potential third party liability/ongoing high value litigation).

Directors should keep a detailed, contemporaneous record of their discussions and decisions.

Enhanced oversight

When faced with anticipated or actual financial difficulties, the first step is to review financial oversight and governance processes. This will often lead to changes to the company's usual approach, and so there may be some resistance, but it is essential, given the emphasis placed on this by the court when reviewing directors' conduct.

Board meetings—Frequent board meetings and detailed board minutes are critical, and directors should be actively engaged in the decision making. Directors should keep a detailed, contemporaneous record of their discussions and decisions in relation to all key matters and reflect the basis for their decisions, including the likely impact on the company and its stakeholders and any financial evidence or professional advice relied on.

For complex issues, it may be advisable for legal and financial advisers to join board meetings for direct input.

Financials—Accurate information is key.

Directors should ensure they receive regular and up-to-date financial information, containing detailed cash flow and balance sheet positions, and understand and satisfy themselves as to the underlying basis, methodology, assumptions and sensitivities of any financial projections (and reflect this in board minutes).

For complex issues, it may be advisable for legal and financial advisers to join board meetings.

Entity-by-entity approach—For groups, it is important that the directors of each company satisfy themselves as to the financial position and prospects of the particular entity of which they are a director and are mindful to manage potential conflicts of interest (for example, if a director is an employee of the shareholder or sits on multiple boards in a group).

Enhanced duties

There are a number of additional considerations for directors in the context of anticipated or actual financial difficulties, such as assessing the solvency position of the company (on both a cash-flow and balance sheet basis), the likelihood of an insolvent liquidation or administration, how decisions impact creditors' interests and the weight to be given to them, and whether it is in the interests of the company and its stakeholders to continue trading.

It is prudent for the directors to seek legal advice promptly on their duties.

These considerations are complex and require directors to carefully consider all relevant facts and circumstances. It is prudent for the directors to seek legal advice promptly on their duties and how these might best be discharged in the circumstances. It should be documented

in board minutes that the directors have, at each board meeting, considered the advice and acted upon it.

Scrutiny of transactions

All key decisions should ideally be made at a board meeting, by reference to the latest financial information and professional advice, and be made for genuine business reasons, considering the 'downside case'. Some key guidelines are follows:

- carefully consider the interests of creditors and other stakeholders before entering into transactions or making payments outside of the ordinary course or to related parties (including group companies, management and shareholders);
- do not incur additional debt/obligations unless there is a clear plan for how they might be satisfied when due and they are on reasonable terms in the circumstances;
- be prudent when entering into new longer-term agreements (for example, receiving payment for services upfront, where the contract spans beyond the immediate short term); and
- be mindful of paying certain creditors ahead of others or stretching creditors either on a single creditor basis or groups of creditors without their express consent, or demonstrable creditor dialogue.

Role of advisers

Specialist financial or legal advice can be a vital support for directors in times of financial difficulty, not least because it frees directors up to focus on the business.

- Financial advisers can support the company's finance function in cash management and forecasting, as well as help to develop a turnaround strategy and assist in negotiating with stakeholders.
- Legal advisers can help to set up a streamlined board meetings process and assist with board materials and minutes, advise on directors' duties, identify potential default triggers, develop a legal restructuring strategy and contingency plan and assist in negotiating with stakeholders.

Ultimately, directors will remain responsible for the company's decisions, but professional advice can go a long way in facilitating these decisions during times of uncertainty and, as per the above, it can help demonstrate that directors have discharged their duties.

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