

What do Directors need to know?

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The general sentiment for 2024 is that challenges still lie ahead for business owners before things will improve. How will those challenges impact your business?

Directors need to be aware that in times of doubtful solvency the law requires them to at least have regard to the interests of creditors as well as shareholders, and getting it wrong can attract significant personal liability.

The Supreme Court has had a lot to say about director duties in recent years in the high-profile Mainzeal case and the lesser-known Debut Homes case. Those cases were about the "insolvency duties" in the Companies Act 1993 – directors are not permitted to trade "recklessly" (section 135) or incur obligations without a reasonable expectation of meeting them (section 136).

Those cases made it clear that trading on when you know the company is unsalvageable is not permitted, and that in times of "doubtful solvency" the interests of all creditors must be taken into account.

Some legal commentators argue that the current law in New Zealand does not strike the right balance between corporate risk taking and creditor protection prior to actual insolvency. The criticism is essentially that the test is difficult to apply and weighted too much in favour of creditors. Until the NZ Courts or the legislature provide firmer guidance (as the UK Supreme Court did recently in a case known as Sequana) directors may think that the only choice that guarantees them avoiding personal liability is to shut the doors, resulting in more liquidations than would otherwise occur if directors had more certainty on where the lines are drawn.

So what is a director to do? Here are ten recommendations from our experienced team.

- If solvency is doubtful you have to think about the interests of your creditors.
- Insist upon regular financial reporting that specifically includes reporting on solvency.
- Cash is king. Maintain updated cashflow forecasts and make them realistic – unrealistic forecasts will erode your credibility with the bank just when you need them the most.
- If you are in a solvency squeeze, you are allowed to take some time to take stock, assess solvency and get professional advice. But time is of the essence and don't commit to any major obligations in the meantime.
- Pressured businesses often pay key suppliers while deferring others, that is not unusual and makes sense, but that is also a very slippery slope. More than a temporary blip means you may have crossed the line and should call your lawyer and accountant to talk through options.
- If the company is unsalvageable do not try to trade on, even if you think it would improve the situation. Call your lawyer and accountant immediately. If you do trade on, be aware you could become personally liable for all unpaid obligations incurred

after the date you should have appointed a liquidator.

- An honest belief that things will get better is not enough – the insolvency duties have objective standards and you have to be grounded in reality.
- If action is required to address solvency issues but your fellow directors disagree, make sure your views are recorded in meeting minutes.
- If your fellow directors aren't on the same page with you and the situation worsens, resign – although that may not be an option if it's your company.
- Above all, act quickly. If you take too long to take action you risk creditors taking the decision out of your hands (e.g. by issuing a statutory demand and then appointing a liquidator or, in the case of secured creditors, moving straight to calling in a receiver).

If you think the business could recover, the Companies Act has mechanisms that allow businesses to work through issues with creditors and come out the other side, creditor compromises and voluntary administration are the main two options. But if not, stop pouring good money after bad, winding up the business in a voluntary liquidation may be a tough decision but it may be the best or only option.

If you are a director experiencing or foreseeing solvency issues and want to talk through your options, our Andy Martin and Georgia Thompson are well placed to advise.