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# Newman & Partners

Licensed Insolvency Practitioners

# RECOVERY & REVIVAL BULLETIN

Welcome to the latest issue of our Recovery and Revival Bulletin, designed to keep you up-to-date on insolvency matters that may be of interest to you. If you have any feedback on this bulletin, or would like to know more about our services or how we can help you, please contact us on **020 8357 2727** or at **insolvency@newmanandpartners.co.uk**

## Is your client a zombie company?

**You may have heard the term 'zombie company' used in discussions about struggling businesses, particularly in the context of those barely able to survive financially.**

A zombie company is a business that is barely able to cover its interest payments, let alone reduce the principal debt. These companies typically survive by extending credit lines, delaying payments to creditors, or relying on temporary injections of cash. Despite their continued operation, they lack the financial health to invest in growth or even maintain a stable position in the market. In essence, a zombie company is one that is alive in name only, operating on borrowed time and resources.

For you, as an accountant, recognising a zombie company is crucial. The key indicators include persistent cash flow issues, reliance on short-term borrowing, and an inability to reduce debt levels. Additionally, zombie companies often show signs of distress, such as overdue accounts, a lack of working capital, and an over-reliance on creditors who have yet to enforce repayment.

### What to do if your client is a zombie company

If you identify that your client is a zombie company, immediate action might be necessary. The first step is to conduct a thorough review of their financial position, focusing on cash flow, debt levels, and the overall sustainability of their business model. This will help determine whether there is any realistic prospect of recovery or whether insolvency proceedings should be considered.

It is also essential to communicate openly with your client. Many directors of zombie companies may be in denial about the severity of their situation. As their accountant, your role includes providing clear, evidence-based advice. This may involve recommending cost-cutting measures, restructuring debt, or refinancing. However, if these steps do not offer a viable path to recovery, it may be time to consider formal insolvency procedures.

### When to speak with an insolvency practitioner

If your client's financial difficulties persist despite your best efforts, or if they are unable to meet their obligations as they fall due, it is time to act. Delaying this decision can result in worsening financial circumstances, increased creditor pressure, and potentially personal liability for the company's directors.

As an accountant, you are in a unique position to recognise when a client is on the brink of insolvency. Speaking with an insolvency practitioner sooner rather than later can help protect the interests of the creditors, the directors, and, where possible, the business itself. By engaging with Newman & Partners, you can ensure that your clients receive expert advice tailored to their specific circumstances, whether that involves restructuring, liquidation or administration.

Early intervention can make the difference between an orderly process and a chaotic collapse, so do not hesitate to seek professional guidance when needed.

If you think your client may be a zombie, please get in touch with our team on **020 8357 2727** or email: **insolvency@newmanandpartners.co.uk**

# How are directors' loans treated during insolvency?

**As an accountant, it's essential to understand how directors' loans are treated during insolvency. These loans can be a particularly complex aspect of a company's finances, and their treatment during insolvency can have significant implications for both the director and the company's creditors.**

A directors' loan occurs when a director either borrows money from or lends money to their company. As you know, these transactions are recorded in the Directors' Loan Account (DLA), which tracks all financial dealings between the director and the company that are not related to salary, dividends, or expense reimbursements. Directors' loans can result in either an overdrawn account, where the director owes money to the company, or an account in credit, where the company owes money to the director. The treatment of these loans becomes especially significant during insolvency.

## Insolvency and directors' loans: The basic principles

During insolvency, a company's financial situation undergoes close scrutiny by an insolvency practitioner whose primary goal is to maximise returns to creditors. Directors' loans form an important part of this assessment, and the treatment of these loans largely depends on whether the directors' loan account is overdrawn or in credit.

If the directors' loan account is overdrawn, the director owes money to the company. In the context of insolvency, this debt is considered an asset of the company, and the insolvency practitioner will seek to recover the amount owed. Essentially, the director becomes a debtor to the company, and like any other debtor, they are expected to repay the amount due. If the director does not voluntarily repay the loan, the insolvency practitioner may pursue legal action to recover the funds. This situation can put the director in a difficult position, as failure to repay the overdrawn amount could lead to personal financial difficulties, including the risk of bankruptcy. Moreover, if it is determined that the loan was taken improperly or without the intention or ability to repay it, the director could face personal liability beyond just the repayment of the loan.

There is also the risk of a misfeasance claim if the overdrawn loan is substantial and was taken when the company was either insolvent or heading towards insolvency. Misfeasance, in this context, refers to the improper conduct or breach of fiduciary duties by the director. If the loan is deemed to have been taken improperly, the director could be required not only to repay the loan but also to compensate the company's creditors for any resulting losses.

On the other hand, if the directors' loan account is in credit, meaning the company owes money to the director, the director is treated as an unsecured creditor during insolvency. As an unsecured creditor, the director's claim for repayment is ranked alongside those of other unsecured creditors, such as suppliers and trade creditors. In the insolvency process, creditors are paid in a specific order of priority, starting with secured creditors, followed by preferential creditors (such as employees owed wages), and finally, unsecured creditors. The chances of the director recovering the full amount owed to them depend on the remaining assets of the company after higher-priority creditors have been paid. In many cases, unsecured creditors receive only a fraction of what they are owed, if anything at all.

In some situations, there may be an opportunity to offset amounts owed by the company to the director against any amounts owed to the company by the director, including overdrawn loans. This set-off provision can sometimes mitigate the impact on the director if they are both a debtor and a creditor of the company.

## Tax implications of directors' loans during insolvency

The treatment of directors' loans during insolvency also involves significant tax considerations, which vary depending on whether the loan is overdrawn or in credit.

For overdrawn loans, there is a corporation tax charge under Section 455 of the Corporation Tax Act 2010 if the loan is not repaid within nine months after the end of the company's accounting period. This tax charge is currently set at 32.5 per cent of the outstanding loan amount. If the loan remains unpaid during insolvency, the insolvency practitioner will include this tax charge as part of the company's liabilities. However, if the director repays the loan, the company can reclaim the Section 455 tax charge, although the likelihood of repayment during insolvency may be low, potentially increasing the financial burden on the insolvent company's estate.

For directors' loans that are in credit, there are generally no immediate tax implications during insolvency. However, the director should still consider any interest received on the loan as taxable income, and this interest could be at risk if the company is unable to repay the loan. If the loan is unlikely to be repaid due to insolvency, the director may be eligible to claim bad debt relief, allowing them to offset the irrecoverable loan against taxable capital gains. However, specific conditions must be met to qualify for this relief, and professional advice should be sought.

## Practical considerations for directors during insolvency

As an accountant advising directors who are facing insolvency, there are several practical steps you can suggest to mitigate the risks associated with directors' loans.

Firstly, if the director has an overdrawn loan account, it is crucial to establish a repayment plan as early as possible. A proactive approach can help avoid personal financial liability during insolvency. Additionally, maintaining accurate documentation of all transactions between the director and the company is essential. Incomplete or inaccurate records can complicate the insolvency process and lead to disputes over the loan's legitimacy or repayment terms.

Encourage directors to seek professional advice as soon as financial difficulties arise. Early intervention by an insolvency practitioner or accountant can provide guidance on how to handle directors' loans and other financial matters, potentially avoiding personal liability or other adverse outcomes. Regularly reviewing the directors' loan account is also important to identify potential issues before they become problematic. This review should include ensuring that any loans taken are within the company's financial capacity and that there are clear intentions and plans for repayment.

Directors' loans are a complex and critical aspect of company finances, particularly during insolvency. Whether the loan is overdrawn or in credit, the implications for both the director and the company can be significant. As an accountant, it's essential you advise directors on the importance of managing their loan accounts carefully and being aware of the potential risks during insolvency.

We can guide you on helping directors navigate the challenging process of insolvency while minimising their exposure to personal liability and financial loss, please get in touch with our team on **020 8357 2727** or email: **insolvency@newmanandpartners.co.uk**

# When is a director personally liable for company debts?

**As an accountant, you should have some understanding of when a director – one of your clients – might be held personally liable for their company's debts. Directors too need to be aware of the situations where the protection of limited liability may not apply. Here, we provide you with a comprehensive overview of those circumstances, offering you the knowledge needed to advise directors effectively and help them avoid potential pitfalls.**

## Understanding limited liability and its exceptions

The concept of limited liability is foundational in corporate law, this shields directors and shareholders from personal responsibility for the company's debts. Under normal circumstances, the company's obligations are separate from the personal assets of its directors and shareholders. This separation, often referred to as the 'corporate veil,' is what protects individuals from being personally liable for the company's financial troubles.

However, this protection isn't absolute. There are situations where the corporate veil can be pierced, exposing directors to personal liability. Understanding these exceptions is crucial for advising your clients effectively.

One of the most serious exceptions is fraudulent trading. Under the Insolvency Act 1986, fraudulent trading occurs when a company continues to trade with the intent to defraud creditors, knowing there's no reasonable prospect of paying them. This is a deliberate and dishonest act. If a director engages in fraudulent trading, they can be held personally liable, and the court may require them to contribute to the company's assets. Additionally, they could face criminal charges.

Another significant exception is wrongful trading. While less severe than fraudulent trading, wrongful trading still carries considerable risks. Wrongful trading happens when directors allow a company to continue trading even though they know, or should know, there is no reasonable prospect of avoiding insolvency. Unlike fraudulent trading, wrongful trading doesn't involve intent to deceive.

However, the law expects directors to take every reasonable step to minimise potential losses to creditors once insolvency becomes inevitable. If they fail to do so, they can be held personally liable, with the courts ordering them to contribute to the company's assets.

In addition to these statutory liabilities, personal guarantees are another area where directors can find themselves personally liable. Often, directors provide personal guarantees to secure financing or other obligations for the company. While these guarantees can be crucial for obtaining necessary resources, they effectively bypass the protection of limited liability. If the company fails to meet its obligations, creditors can enforce these guarantees against the director's personal assets. When advising directors, you must ensure they fully understand the implications of signing personal guarantees and assess the risks involved.

Directors are also bound by fiduciary duties under the Companies Act 2006, which require them to act in the company's best interests, avoid conflicts of interest, and exercise care, skill, and diligence. Breaching these duties can lead to personal liability, particularly when such breaches result in financial losses to the company or its creditors. For example, if a director prioritises their personal interests over those of the company, they could face legal action resulting in personal liability.

## Navigating the risks and protecting yourself

The legal doctrine of piercing the corporate veil further complicates the issue of personal liability. While the courts generally uphold the principle of limited liability, they may pierce the corporate veil in cases where the company structure has been used to perpetrate fraud or avoid existing obligations. If the veil is pierced, the director's personal assets can be targeted to satisfy company debts. This is a rare but serious risk and understanding the circumstances in which it might occur is vital for both you and your clients.

Given these risks, it's important to advise directors on how they can minimise their exposure to personal liability. Diligence and compliance are key. Directors must ensure they maintain proper records, comply with statutory obligations, and adhere to best practices in corporate governance. As their accountant, you can play a crucial role in guiding them to meet these requirements, helping them avoid potential pitfalls.

Regular financial oversight is another essential strategy for reducing liability risks. Directors should be encouraged to engage in proactive financial management, regularly reviewing the company's financial health and taking early action when signs of distress emerge. This approach can help prevent situations where they might be accused of wrongful trading.

Finally, avoiding conflicts of interest is crucial. Directors should be advised to disclose any potential conflicts and ensure that their decisions are always in the best interests of the company. Transparency and integrity are vital in maintaining the trust of both the company and its creditors.

As an accountant, you are in a unique position to help directors navigate the complexities of personal liability. By understanding the exceptions to limited liability and advising directors on best practices, you can help them protect themselves from personal risk. While the principle of limited liability offers protection, it's not fool-proof. Directors must be diligent, proactive, and transparent in their dealings to safeguard their personal assets from potential claims.

The knowledge and guidance you provide can make the difference in ensuring that directors understand their responsibilities and the consequences of their actions. As the economic environment becomes increasingly challenging, this understanding is more important than ever.

If you'd like further information or advice, please get in touch with our team on **020 8357 2727** or email: **insolvency@newmanandpartners.co.uk**

**CAREFUL CONSIDERATION IS NEEDED BEFORE TAKING OUT ANY FORM OF FINANCE AND SPECIALIST ADVICE SHOULD BE SOUGHT. IF YOU HAVE ANY QUESTIONS, PLEASE CONTACT US.**

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