

***Fergal McManus advises that in the current difficult trading conditions we are likely to see a lot more instances of the Courts making Directors liable for some or all of the debts of insolvent companies.***

## **When can a Director be made personally liable for the Debts of a Company**

As the economic difficulties continue Company Directors are increasingly facing the prospect of Liquidation. In answering the question posed one must first understand the difference between Shareholders and Directors. Shareholders are the members of the Company who contributed capital (even if only nominal) when the Company was incorporated or else they acquired Shares in the Company at a later stage. In the traditional sense it is the shareholders who have limited liability i.e. if the company is insolvent then the Creditors of the Company cannot chase the shareholders personally for the Company debts. Apart from one or two technical exceptions, Shareholders do not have anything to worry about in the context of Insolvency. The matter is quite different for Directors who are the persons appointed by the Shareholders to run the Company. In a small private company the Shareholders and Directors are very often one and the same people. Nevertheless the distinction is important and it is understandable that the law should impose a significant burden on those running the Company to do so in a reasonable manner and without abusing the benefits of limited liability. Generally it is in the context of Directors who allow their Company to continue to trade while such a Company is insolvent which triggers personal liability. There are three main instances in which a Director may be made personally liable for the debts of the Company. These are:

1. Fraudulent Trading
2. Reckless Trading
3. Failure to keep proper Books of Account

We examine each of these below: -

### **FRAUDULENT TRADING**

Fraudulent Trading is also a criminal offence but in the context of attaching personal liability to the Directors, it arises where the Directors intended to defraud the creditors of the Company and had knowledge of such intent. Essentially if the Directors of the Company continue to carry on business or to incur debts at a time when they know that there is no prospect of paying the Creditors or indeed if the Directors incur Credit on behalf of a Company knowing that there is no good reason to think that funds will be available to pay the Debt when it becomes due or shortly thereafter. Such conduct on the Directors part constitutes fraudulent trading. The Courts may impose personal liability on Directors found to have fraudulently traded on the basis of a compensatory or punitive award. By compensatory it is meant that the director will be made personally liable for the loss caused to the company directly

referable to the fraudulent trading. This may only constitute part of the debts of the Company. More dangerously for a director, the court is entitled to make the director personally liable for the entire debts of the Company where there has been a serious wrong doing and where the Court believes that a punitive award is appropriate.

## **RECKLESS TRADING**

Reckless trading is a more difficult concept to encapsulate in a short definition. There are a number of tests but the element of reckless trading that is likely to concern most Directors is known as “Deemed” Reckless Trading where a Director can be made personally liable if he was a party to the contracting of a debt by the Company and did not honestly believe on reasonable grounds that the Company would be able to pay the debt when it fell due for payment as well as its other debts (taking into account contingent and perspective liabilities). Obviously this is a cause of great concern to directors who perhaps are experiencing cash flow difficulties. In an era where many businesses are experiencing cash flow problems it is very easy for a Director to fail that test and expose him or herself to the prospect of personal liability. The courts approach in imposing personal liability is based on the amount of the Company’s loss directly referable to the reckless trading. Unlike fraudulent trading personal liability cannot be imposed on a punitive basis for the entire debts of the Company. The law does however provide a defence where the director can show that he or she acted honestly and responsibly in relation to the conduct and affairs of the Company.

## **FAILURE TO KEEP PROPER BOOKS OF ACCOUNT**

Personal liability for the Director arises where the Court considers that the failure by the Directors to keep proper books of account has contributed to the Company’s inability to pay its debts or has resulted in a substantial uncertainty as to the assets and liabilities of the Company or it substantially impeded the ordinarily winding up of that company. The Courts approach in imposing personal liability on foot of this heading tends to be on the basis of the loss resulting to the Company by virtue of the failure to keep proper Books of Account. It does not trigger personal liability by the Directors for all of the unpaid Debts of the Company.

## **CONCLUSION**

With the current regulatory environment and the difficult trading conditions we are likely to see a lot more instances of the Courts making Directors liable for some or all of the debts of insolvent companies. The advice is simple, if you are getting into trouble consult your Accountant and Solicitor at the earliest opportunity.

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