PRACTICE NOTE

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Risks for Transactions and Directors in Financially Distressed Businesses (Ireland)

by Julie Murphy-O'Connor and Edward Kane, Matheson LLP

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A Practice Note addressing the legal and practical considerations in Ireland for a company director where that company is in financial distress and may subsequently enter a restructuring or insolvency process. This Note also outlines the types of claim that an official appointed to oversee the restructuring or insolvency process or represent the creditors' interests, or both, may bring against the company's former directors, or to unwind transactions that took place before any restructuring or insolvency process commenced.

When a company is in financial distress and enters into a restructuring or insolvency process, there are a variety of legal and practical issues to consider. Before a distressed company goes into such a process, its directors will need advice on what they need to do to fulfil their duties to the company, its creditors and shareholders, and will need to consider the status of any ongoing transactions the company may be engaged in. Once the company enters into a formal insolvency process, the prior actions of the directors are likely to be scrutinised by the restructuring or insolvency official(s) appointed.

This Note considers the legal and practical issues involved under the law of Ireland and addresses:

- The duties that directors owe to their company, its shareholders and its creditors, and how these may change according to the company's financial situation.
- The investigation of the actions of the directors by restructuring and insolvency officials.
- The powers of restructuring and insolvency officials to unwind any prior transactions and general powers of recovery in their aim to achieve the greatest possible return for the company's creditors and other applicable aims.
- The potential for any claims against the company's directors, and whether the directors can be personally pursued because of certain conduct even if ordinarily they would not be liable for the insolvent company's debts.

Principal Fiduciary Duties of Directors

The Companies Act 2014 (as amended) (CA 2014) codifies the common law fiduciary duties owed by directors to their companies, placing them on a statutory footing. Section 228 of the CA 2014 contains a statement of the principal fiduciary duties of directors, which include, for example:

- To act in good faith in what they consider to be the interests of the company (section 228 (a)).
- To act honestly and responsibly in relation to the conduct of the company's affairs (section 228 (b))
- To act in accordance with the company's constitution and to use their powers only for the purposes allowed by law (section 228 (c)).
- To avoid conflicts of interest between their duty to the company and their other interests (including personal interests) unless the director is released from this duty (section 228 (f)).
- To exercise the care, skill and diligence that would be exercised in the same circumstances by a reasonable person (having both the knowledge and experience that may reasonably be expected of a person in the same position as the director and with the knowledge and experience that the director possesses) (section 228 (g)).

This is not an exhaustive list and directors also have other more specific statutory duties under the CA 2014 (and otherwise), including, for example, their obligations to keep financial records, to prepare annual financial statements and to ensure that the person appointed to the role of company secretary has the skills or resources necessary to discharge his or her statutory and other duties.

Shadow and de facto directors owe the same duties to companies as directors that are formally appointed.

Although, directors' duties are owed primarily to the company, sections 224 and 228(1)(h) of the CA 2014 provide that directors must also have regard to the interests of the company's employees and shareholders.

How Directors' Duties Change When a Company Is Facing Financial Difficulty

Since July 2022, the European Union (Preventive Restructuring) Regulations 2022 (Preventive Restructuring Regulations) inserted a new section 224A into the CA 2014 requiring a director that believes, or has reasonable cause to believe, that a company is, or is likely to be, unable to pay its debts (within the meaning of section 509(3) of the CA 2014), must have regard to:

- The interests of the creditors;
- The need to take steps to avoid insolvency; and
- The need to avoid deliberate or grossly negligent conduct that threatens the viability of the company's business.

These duties are expressly stated to be owed by directors to the company alone and is enforceable in the same way as any other fiduciary duty owed to a company by its directors (section 224A (2)). This means that creditors do not have a right of action against the directors for breach of the duties. Rather, it is the company, potentially acting through its liquidator, that can hold the directors to account for any loss or damage resulting from a breach.

It was previously a common law requirement that directors should have regard to the interests of creditors where the directors become aware of the company's insolvency. This has now been introduced as a statutory requirement by the Preventive Restructuring Regulations, including the insertion of a new section 228 (1) (i) in the CA 2014 to this effect.

It can be difficult for directors to identify at precisely what point a company is or is likely to become insolvent. The Preventive Restructuring Regulations inserted a new section 271A into the CA 2014 which provides that directors may have regard to certain early warning tools to alert them to circumstances that could give rise to a future insolvency. The Corporate Enforcement Authority (CEA) subsequently published its Information Note 2023/1 on the Preventive Restructuring Regulations, Early Warning Tools and Restructuring Frameworks, which provides at Appendix 1 a non-exhaustive list of indicators of actual or potential financial difficulties, to assist companies and their directors.

In the English Supreme Court decision of *BTI v Sequana* a "real risk" of insolvency was not considered to be sufficient to trigger the creditors' interest duty. The correct test was found to be that:

> "the directors know or ought to know, that the company is insolvent, or bordering on insolvency, or that an insolvent liquidation or administration is probable".

In July 2024, the English High Court described this as the "modified *Sequana* duty" in *Re BHS Group Limited (In Liquidation)* a case where a novel offence of "trading misfeasance" (continuing to trade in breach of the creditor duty when a company is insolvent or bordering on insolvency) was also considered. Whilst the Sequana judgment has not yet been considered by the Irish courts, the test described in it is similar to what is provided in the Preventive Restructuring Regulations.

Effectively, therefore, once directors become aware of a company's impending insolvency, the company holds its assets on trust for its creditors, and the directors must take all steps to minimise additional potential loss to them. Directors should consider the appropriate restructuring or insolvency process for the company. The main processes available are:

- **Statutory schemes of arrangement:** a company can reach an agreement with its members or creditors under Part 9 of the CA 2014.
- **Examinership:** under Part 10 of the CA 2014, companies with a reasonable prospect of survival can seek the protection of the court from their creditors for a period of up to 100 days to allow an examiner to formulate a scheme to restructure the companies' debt and present it to creditors and to the court for approval.
- **Small company administrative rescue process (SCARP):** small and micro companies (as defined by section 280D of the CA 2014) with a reasonable prospect of survival may use this process to restructure with creditor consent without the requirement for court approval.
- **Receivership:** although this process is often used by secured creditors to enforce their security, it is also possible to restructure companies by way of a pre-pack receivership.

- **Liquidation:** where it is clear that a company cannot trade out of its difficulties and is insolvent, it can be wound up voluntarily by way of a shareholders' resolution followed by a creditors' meeting (creditors' voluntary liquidation) or compulsorily by order of the High Court (compulsory liquidation).

No mandatory triggers exist under Irish law for entry into restructuring or insolvency procedures. There are two tests for insolvency:

- Unable to pay its debts as they fall due (section 509 (3) (a)) (the cash-flow test); or
- The value of its assets is less than its liabilities, taking into account its contingent and prospective liabilities (section 509 (3) (b)) (the balance-sheet test).

If certain conditions are met concerning unsatisfied statutory demands for payment or unsatisfied judgments or court orders in favour of creditors (as described by section 570 of the CA 2014), a company will be deemed insolvent (section 509 (3) (c)). This is commonly relied on where a creditor is seeking to liquidate the company. This is because it can be relied upon even if the company has a strong asset position.

The cash-flow test is used when assessing whether a transaction may be vulnerable to challenge under insolvency claw-back legislation. However, commercial contracts and finance documents often refer to the balance-sheet test. The balance sheet test can be easily triggered, particularly if a company has significant borrowings. It is therefore more important for directors to focus on the cash-flow test in the short term, while at the same time planning how to reduce the balance sheet deficit in the longer term.

Examination Of Directors' Pre-Insolvency Actions During Insolvency Processes

Restructuring and insolvency practitioners are afforded various powers by the CA 2014 to assist in investigating companies' affairs. Under Regulation (EU) 2015/848 (Recast), which provides for mutual recognition of insolvency proceedings, those powers will also be recognised in other EU member states.

Access to Books and Records

Pursuant to section 624 of the CA 2014, a liquidator has a duty to gather the books, seals, and records of the company, as well as any property of the company.

Pursuant to section 526 and 558ZT of the CA 2014 respectively, an examiner or SCARP process adviser has a right of access to books and records of the company and all officers and agents of the company are required to make available any company records in their possession.

The CEA has the power, pursuant to section 653 of the CA 2014, to request the books and records of a company that is being wound up and they may ask questions in relation to the books and records of any appropriate person, including a former director.

Pursuant to section 446 of the CA 2014, a receiver may also be required by the CEA to produce their books in relation to a receivership and to answer any questions in relation to them.

Powers of Examination, Search, Seizure and Arrest

Pursuant to section 671 of the CA 2014, at any time after the appointment of a provisional liquidator, the making of a winding up order or the passing of a resolution to wind up a company voluntarily, the court may (of its own motion, or on the application of the CEA or a liquidator or provisional liquidator) make an order for examination under oath of an individual and the court may order that person to produce any money, property, books, or papers in their power or possession.

The persons who may be examined include any officer of the company, or any person known or suspected to have in his or her possession any property of the company or supposed to be indebted to the company or any person who the court deems capable of giving information relating to any of these matters. The examination can be oral or by way of interrogatories.

If a person fails to attend the examination without reasonable excuse, the court may cause that person to be arrested and for their books and documents and moveable personal property to be seized or secured and detained until such time as the court may order.

Pursuant to section 672 of the CA 2014, the court may, in the course of an examination, also order that person to repay any debts or return any money, property, books or other papers of the company to the liquidator and the CEA or liquidator can apply for an order to enter, search and seize property of the company.

Where there is a risk of a person absconding or disposing of or concealing their property to avoid payment or examination, section 675 of the CA 2014 empowers the court to order that they be arrested or that the relevant property be seized.

Investigations

In addition to the above powers, the CEA can also request the court to appoint inspectors pursuant to section 748 of the CA 2014 to investigate the affairs of the company where circumstances suggest that there has been fraudulent or unlawful activity. Members of An Garda Síochána, who are also CEA officials, are also empowered to effect arrests and apply for search warrants in certain circumstances.

The CEA's powers in relation to the investigation of corporate offences have been recently expanded by the Companies (Corporate Governance, Enforcement and Regulatory Provisions) Act 2024, certain provisions of which commenced with effect from 3 December 2024.

Applications for Restriction and/or Disqualification of Directors

A liquidator's main obligation is to take possession of, and realise, the assets of the company and to distribute the proceeds among the creditors in accordance with the rules on priority.

In an insolvent liquidation, the liquidator must prepare a report for the CEA within six months of their appointment (and as required by the CEA after that) regarding the conduct of the directors of the company. The liquidator is required to make an application to court to restrict each of the directors of the company unless expressly relieved of that obligation by the CEA. Liquidators may also seek or be directed to bring an application to disqualify some or all of the directors.

Where a court application is required, liquidators will generally seek the costs of the application, as well as the costs and expenses incurred in relation to investigating the matters leading to the application.

Restriction

Restriction prevents a director of an insolvent company from acting as an officer of any other company for a period of up to five years, unless that company has an allotted share capital of not less than EUR100,000 for a private company or EUR500,000 for a public company and all shares must be paid for in full. A restriction order can be imposed on any person who was a director (or de facto or shadow director) of an insolvent company either at the date of or within 12 months prior to the commencement of its winding up.

Section 683 of the CA 2014 provides that a liquidator must bring a restriction application pursuant to section 819 of the CA 2014 unless expressly relieved of that obligation by the CEA. The liquidator's obligations will continue to apply until the conclusion of all proceedings under section 819 and therefore includes an obligation to defend any appeal brought by a director. Restriction applications may also be initiated by receivers of the property of a company and by the CEA directly.

The court will make a restriction order unless the director can satisfy the court that they have acted honestly and responsibly in relation to the company, that they have cooperated with the liquidator and that there is no other reason why it would be just and equitable to make such an order against them. The restriction order is then recorded in the register of restricted directors maintained by the Companies Registration Office (CRO).

Section 852 of the CA 2014 also provides an alternative administrative procedure whereby the CEA may allow a director to provide a restriction undertaking instead of being the subject of a court application. The restriction undertaking sets out the facts that the CEA believes justify the restriction and the director is asked to sign and return the acceptance document, which the CEA will then submit to the CRO for inclusion on the restriction register. In its first Annual Report, published in June 2024, the CEA confirmed that the majority of restrictions between July 2022 and December 2023 were implemented by way of undertaking rather than requiring an application to court.

Disqualification

Disqualification is sought where there is evidence of more serious wrongdoing on the part of a director. It prevents a director from acting as a director or other officer, statutory auditor, receiver, liquidator or examiner of any company or being involved in any way with the promotion, formation, or management of a company.

A disqualification order can be made by the court pursuant to section 842 of the CA 2014 for such period as the court decides. Alternatively, the CEA may at their discretion offer a director the opportunity to sign their acceptance of a disqualification undertaking for a maximum period of 5 years instead of making a court application. Again, the CEA's first annual report notes that the majority of disqualifications made between July 2022 and December 2023 were made by way of the undertaking procedure.

A director may also be automatically disqualified pursuant to section 839 of the CA 2014 for a period of 5 years or longer if they are convicted of any offence under the CA 2014 on indictment or any offence involving fraud or dishonesty.

Applications for disqualification may also be brought by a liquidator, examiner, or receiver on the grounds set out in section 842 (a) – (d) of the CA 2014 if they are satisfied the director is guilty of fraud or breach of duty or is not fit to be involved with the management of a company. The CEA can also make an application for restriction and has a broader range of grounds (section 842 (a) – (i) of the CA 2014) including for example persistent default by a director in relation to filing accounts or returns, where a director is disqualified in another jurisdiction and/or where the company has been struck off the register. Unlike a restriction order, the onus is on the liquidator or other applicant to show that the director's conduct justifies a disqualification order. The CEA published a detailed Information Note 2024/1 on circumstances leading to disqualification under the CA 2014 and the associated consequences in January 2024.

Other Potential Applications Against Former Directors

In addition to being potentially subject to restriction or disqualification orders as outlined above, when a company enters into a restructuring or insolvency process its directors can (in certain circumstances) be held to be personally liable for:

- Reckless trading.
- Fraudulent trading.
- Failing to keep proper books of account.

Restructuring and insolvency officials also have a duty to report to the CEA and the Director of Public Prosecutions (the DPP) if it appears that a present or past officer is guilty of an offence in relation to the company. In a court ordered liquidation, the court may also refer the matter to the DPP. Where the receiver makes a report to the DPP, this will also be reported to the CEA.

Reckless Trading

Where a director is party to the carrying on of the business of a company in a reckless manner, then pursuant to section 610 of the CA 2014, the court may hold such person to be personally responsible without limit for all or any part of the debts or other liabilities of the company. A reckless trading application can brought by a liquidator, examiner, process advisor, receiver or creditor/contributory of the company in the course of a winding up, receivership, examinership or SCARP.

A director may be found to be a party to reckless trading where it is shown that either:

- Having regard to the general knowledge, skill, and experience that might reasonably be expected of a person in that position, the director ought to have known their actions would be likely to cause loss to any creditor of the company, or
- The director was party to the contracting of a debt that they did not honestly believe on reasonable grounds that the company would be able to pay that debt when it fell due for payment as well as all its other debts (taking into account the contingent and prospective liabilities).

The reckless trading provisions of the CA 2014 were amended with effect from 1 July 2024 by the Employment (Collective Redundancies and Miscellaneous Provisions) Act 2024. It is now a defence to a reckless trading application for a director to show that they took such steps as were reasonably practicable to minimise the loss to creditors as soon as they knew or ought to have known their actions were likely to cause the loss.

Fraudulent Trading

Where a person is found to have knowingly been a party to the carrying on of the business of a company with intent to defraud its creditors, or for any fraudulent purpose, the court may hold, also pursuant to section 610 of the CA 2014, such person to be guilty of fraudulent trading.

A fraudulent trading application can be brought by a liquidator, examiner, process advisor, receiver or creditor/contributory of the company in the course of a winding up, receivership, examinership or SCARP. The application can be brought against any person (including shareholders and other company controllers) and not only directors.

The intent to defraud may involve putting another's financial interests at risk without a reasonable prospect of repayment. Examples of fraudulent trading include:

- Diverting monies payable to the company to a director or shareholder.
- Incurring credit at a time when, to the knowledge of the director, there is no prospect of that credit being repayable.

- Non-payment of monies to employees or to pension funds.

Civil liability applies when fraudulent intent is proven during the company's winding up, with the offender potentially being held personally liable for the company's debts.

Fraudulent trading is also an offence pursuant to section 722 of the CA 2014 and, in addition to such a director being held by the court to be personally responsible for all or any of the debts of the company, section 871 of the CA 2014 provides for a maximum penalty on conviction on indictment to a fine not exceeding EUR500,000 or imprisonment for a term not exceeding ten years or both. Criminal fraudulent trading has a higher standard of proof and requires proof beyond reasonable doubt.

Failure to Keep Proper Books of Account

A director of a company that is being wound up may also be made personally liable for some or all of the company's debts pursuant to section 609 of the CA 2014 if the court finds that proper accounts were not maintained by the company and that failure has either contributed to the company's insolvency, resulted in substantial uncertainty as to the assets and liabilities of the company, or substantially impeded the orderly winding up of the company.

The court may also find such a director to be guilty of a criminal offence under the CA 2014 and impose a fine of up to EUR500,000 and/or imprisonment for a term not exceeding ten years or both.

To avoid liability under this section, a director must satisfy the court that they took all reasonable steps to secure compliance with their obligations under the CA 2014 to keep proper records or that they had reasonable grounds for believing–and did believe–that a competent and reliable person had been formally and appropriately allocated the responsibility of ensuring that the company's obligations were being fulfilled.

Reporting of Irregularities by Examiner

Examiners are under a duty to report substantial disappearances of property or other serious irregularities in relation to the affairs of a company to the court pursuant to section 533 of the CA 2014 and the court can make such orders in relation to those matters as it considers necessary.

Orders Restraining Removal of Receivership Property

Section 798 of the CA 2014 allows receivers to make an application to the court to restrain directors from reducing or removing company assets from the State. The receiver must have a qualifying claim over the assets and must be able to show that they have sufficient grounds for believing that the assets will be removed or reduced to be successful.

Transactions That Can Be Challenged and Unwound If the Company Enters into a Restructuring or Insolvency Process

Given the obligation to realise assets for the benefit of the company's creditors, a liquidator will review a company's transactions in the period leading up to insolvency to assess if any assets should rightfully be returned to form a part of the pool of assets to be distributed to creditors.

Certain transactions completed prior to the commencement of a winding up of a company may subsequently be deemed invalid under the CA 2014, or may be set aside following an application to the court by the liquidator or other specified parties. Contributions to the debts of an insolvent company can also be sought from related companies in certain circumstances.

Voluntary Dispositions

Section 602 of the CA 2014 provides that, following a winding up, dispositions of the property of the company (which includes the sale of shares in the company and the charging of company property), without the sanction of the liquidator of the company, or in certain specific circumstances a director, shall, unless the court otherwise orders, be void.

Unfair Preference

Unfair preference is the wrongful favouring of one creditor over others by a company which is unable to pay its debts. Pursuant to section 604 of the CA 2014, any transaction in favour of a creditor that took place within a specified period before the commencement of a winding up of the company, and was done with a view to giving that creditor a preference over other creditors of the company, is deemed an unfair preference and is invalid.

The look-back period for such transactions is six months prior to the commencement of a winding up, or two years if the transaction was in favour of a connected person such as a director, or (in both cases) such longer period as the court considers just and equitable. The company must have been, at the time of the commencement of the winding up, unable to pay its debts (taking into account the contingent and prospective liabilities).

A defence to an allegation of making an unfair preference is to establish that the alleged act was not carried out with the dominant intention of giving one creditor preference over other creditors. Any repayments of debts owed to directors or shareholders or other connected parties during that period are likely to be closely scrutinised by a liquidator.

Fraudulent Disposition

Where any assets of a company in liquidation have been disposed of with the effect of perpetrating a fraud against the company, its creditors or its members, any liquidator, creditor or contributory of the company may apply to court pursuant to section 608 of the CA 2014 to seek the return of those assets.

The court may order that the property concerned should be returned or, alternatively, that an amount be paid to the liquidator on terms decided by the court. In reaching its decision, the court will take into account the rights of any bona fide purchaser for value who has acquired the property.

Unlike unfair preferences, for the purpose of section 608, it is irrelevant that the company was insolvent at the time of the disposition or that it was made to a creditor or that the disposition was made within a certain timeframe. There needs only to be a disposal where the effect is to perpetrate a fraud on the company, its creditors or its members. However, section 608 will not apply where section 604 (unfair preference) applies.

Receivers and examiners may similarly apply to court for the return of property that was improperly disposed of (sections 557 and 443 of the CA 2014 respectively) and the court is empowered to make similar orders in respect of its return.

Creation of Floating Charge Within 12 Months of Insolvency

If a floating charge was created less than 12 months before the winding up commenced (or within two years in favour of a connected person, such as a director), it will be invalid pursuant to section 597 of the CA 2014, unless it can be shown that the company was solvent immediately after creating the charge. However, it will not be invalid in respect of money paid to the company or the value of any goods or services actually provided in consideration of the charge (and any interest applicable at the appropriate rate) .

Pursuant to section 598 of the CA 2014, a floating charge created within 12 months of the commencement of a winding up in relation to the discharge of a debt to any connected person (including a spouse or child of a company officer) within that period, will also be deemed invalid to the extent of any repayment of such indebtedness, unless it can be proven that company was solvent immediately after its creation.

Improper Use of Company Property

If a liquidator (or any creditor or contributory of the company or the CEA) believes that company officers have misapplied, retained or become liable or accountable for any money or other property of the company, or are guilty of any breach of trust in relation to it, they can, pursuant to section 612 of the CA 2014, apply to court for an order compelling the return or restoration of that money or property and/or that a contribution be made to the assets of the company to compensate it for the misuse.

Contribution and Pooling Orders

Where there are insufficient assets a liquidator can apply to court pursuant to section 599 of the CA 2014 for an order requiring a related company to contribute to the debts of the insolvent company.

Two or more related companies may be wound up together by court order as if they were one company pursuant to section 600 of the CA 2014.

A court may make these orders if it is satisfied that it is just and equitable to do so and on such terms as it may specify.

In deciding whether it is just and equitable to make orders of this nature, a court will have regard to (among other things):

- The extent to which any of the companies took part in the management of any of the other companies;
- The conduct of any of the companies towards the creditors of any of the other companies;
- The extent to which the circumstances that gave rise to the winding up of any of the companies are attributable to the actions or omissions of any of the other companies; and

- The extent to which the businesses of the companies have been intermingled.

An order will not be made simply because one company is related to another, or because the creditors of the company being wound up have relied on the fact that another company is or has been related to the first company.