Potential Shareholder and Director Liabilities in Troubled Investee Companies

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Introduction

Recent news out of the Nigerian National Bureau of Statistics (NBS) has confirmed that, as of the end of the second quarter of 2016, the country had gone into recession for the first time in over twenty years. In a news conference held in September 2016 however, the Governor of the Central Bank of Nigeria suggested that the country’s economy may have already hit the bottom, and hence was likely to return to positive growth by the end of 2016.

Pending the predicted return to growth however, quite a number of Nigerian businesses have continued to bleed as a result of the inclement macroeconomic conditions and, more particularly, the drastic devaluation of the local currency over the past year and a half, as well as the severe shortage of foreign exchange in the economy.

Against this background, private equity investors and others with interests in Nigerian businesses would naturally be seeking measures aimed at storm-proofing their investments. And where the relevant businesses happen to be in financial difficulty, such investors are likely to be concerned about any potential exposure to shareholder or director liability resulting from activities of the ailing businesses.

This article considers the risk of such liabilities and provides guidance on practical steps that may be taken to address those risks.

Would an investor be exposed to any liability by virtue of its status as a Shareholder of an ailing company in Nigeria?

Based on the strict application of the concepts of the separate personality of the company and limitation of liability, shareholders of a Nigerian limited company, whether it is solvent or insolvent, are generally not liable for the debts of the company.\(^2\) Hence except for any associated reputational issues or any contractually agreed additional funding commitments on its part, an investor in a financially stressed company is highly unlikely to incur any liabilities merely on account of their status as shareholder.

For completeness though, there are certain very limited circumstances under which the veil of incorporation of the company could be lifted by the courts so as to expose a shareholder to liability along with or in place of the company, and these include, fraudulent trading (discussed in more detail below in relation to directors), and such inapplicable cases as companies formed for purposes of fraud, illegality or tax evasion.

Where an investor has one or more representatives on the board of the company, would they be exposed to any liability by virtue of their position or role as such director(s)?

Directors of a Nigerian company are subject to a number of duties to the company, the breach of which may (in certain specific circumstances) lead to personal liability, or disqualification from company directorship or management.

The directors have a duty to act in such a manner as to promote the success of the company for the benefit of its shareholders as a whole. And this duty remains in place at all times during the life of the company – from incorporation to liquidation or dissolution.

\(^2\) We have assumed that the investee business would in nearly every case be a limited company, since the other two possible types of company, the unlimited company or a company limited by guarantee are unlikely to be used in practice. And for a number of local reasons non-residents would be unable to invest directly in unincorporated business forms.

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Unlike the position in such jurisdictions as England, where the duties of the directors are said to shift from serving the interests of the shareholders to those of creditors, when the company enters into the zone of insolvency or financial difficulty, the directors of a Nigerian company continue to owe their duties to the company and its shareholders regardless.

That said however, the directors of ailing companies must at all times be mindful of the risks of being found liable for fraudulent or reckless trading, misfeasance or breach of duty. These considerations are relevant for present or previous, as well as substantive, alternate or shadow directors, a shadow director being a person on whose instructions substantive director(s) of a company are accustomed to act.

**Fraudulent or reckless trading**

Liability for fraudulent or reckless trading may only arise after a company has gone into liquidation. And it would arise where the business of the company is found to have been carried on in a reckless manner or with an intention to defraud creditors of the company or creditors of any other person for any fraudulent purpose.

In other words, liability for reckless trading may be established even if there is no fraudulent or dishonest intention, provided that there has been recklessness in the conduct of the business of the company, and that liability may attach not only to the management or to directors, but also to anyone who is knowingly party to the fraudulent or reckless trading.

Investors and their representatives on the boards of investee companies should therefore be careful not to allow the company to trade and incur debt at a time when they know or should reasonably have known that there is no reasonable prospect of that debt being paid when it falls due.

The penalties that a court may impose in relation to fraudulent or reckless trading include personal liability for all or some of the resulting debts or liabilities of the company. Separate from personal liability in the manner just mentioned, a court may impose a penalty of 2 years’ imprisonment or a fine of ₦2,500 (approx. US$8) or both, where the crime is accompanied with intent to defraud as opposed to mere recklessness. In other words, if a director or other relevant person only carried on the business of the company in a reckless manner, without any intent to defraud for fraudulent purpose, no criminal liability would attach to them, however, they may be liable for the debts of the company incurred in such reckless manner.

**Misfeasance and Breach of Duty**

Another possible exposure is liability for misfeasance and breach of duty which may also arise in the course of winding up of the company. Where any present or previous director is found by the court to have misapplied or retained the company’s monies or property, or had been guilty of any misfeasance or breach of duty, such director may be directed by the court to restore such monies or property by way of compensation to the company.

Investors and their representatives on the board should be mindful of a potential review by the courts of any past acts of the directors, and where misfeasance or breach of duty can be established and is found to have resulted in actual loss to the company, such directors may be required to contribute to the assets of the company.

**Group Companies**

Where the ailing company is a member of a group of companies, care must be taken to assess the position of each of those companies separately as the interests of one company may be in conflict with those of others. Directors must therefore at all times be mindful of the fact that their duties are owed to specific standalone companies rather than the group as one body, so as to avoid the risk of incurring liabilities in relation to one company in the pursuit of the interests of an affiliate.

**Disqualification of Directors**

Where, following the company going into insolvency, a court finds after a public examination that any of the directors have committed fraud with, against or in the business of the company, the relevant director may be disqualified from the directorship or management of any company for a period up to 10 years.

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Can one or more directors file for insolvency if they are uncomfortable?

Although directors of a Nigerian company run the risk of liability for fraudulent or reckless trading (as already highlighted), they do not have a duty to put the company into insolvency, nor do they have any direct power to do so. They can certainly recommend that the company file for insolvency, but the legal power to commence the process rests squarely with the shareholders or creditors of the company, or in very special cases, the relevant regulator. That said, it may well be that a determined director could apply to the court to commence insolvency proceedings against the company under the omnibus ground that it is just and equitable in the specific circumstances of the company that it be wound up by the court.

Practical steps to mitigate liability

In order to minimise the risks highlighted in this article, directors and (where applicable) shareholders of Nigerian companies in financial difficulty would do well to take the following common sense steps:

• Obtain formal legal and financial advice in relation to all major steps that they take.

• Actively and regularly review the financial position and solvency of the company, and in this connection, ensure that proper accounting procedures are in place.

• Hold regular, full and proper board meetings which should be properly minuted and, to the extent possible, attended by the company’s or the board’s legal and financial advisers.

• Regularly consider the realistic prospects of the business and such options as a sale, restructuring, or alternative financing.

• Minimise incurrence of new debt except where such debt is essential to keep the company afloat and is in the best interests of the company.

• Be mindful of the risk that any supervisors or managers on whose instructions the director is accustomed to act in the discharge of his directors’ duties may be held to be shadow directors of the company and hence potentially liable to some of the liabilities already discussed.

• To the extent that he has not participated in any act that may be fraudulent or criminal in nature either before or during the winding up of the company, resignation may protect a director from liability. Whether or not this is an appropriate course of action would depend on such factors as its potential impact on the reputation of the director or the investor that they represent on the board, and the resulting inability of the relevant director to continue to play a role in shaping the direction of the company.

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