

CORONAVIRUS RESOURCE CENTER

Suspension of Wrongful Trading Provisions in the UK

Update: the Corporate Insolvency and Governance Bill became law on 25 June 2020. The Bill was amended during its passage through Parliament and section 12(2)(b) of the Act now provides that the “suspension of liability” for wrongful trading applies from 1 March 2020 to 30 September 2020, and may be extended further.

2 June 2020

Unprecedented measures have been taken by governments across the world in response to the COVID-19 crisis. Many of those measures have focused on protecting businesses from the financial impact of government-imposed lockdowns, in order to facilitate the eventual economic recovery. One specific concern has been that insolvency law, and the prospect of personal liability for directors, could push companies that are otherwise viable into insolvency procedures, or into taking unwarranted and hard-to-reverse measures. In the UK, the policy responses to that concern are now taking shape.

Background

On 28 March 2020, the UK Business Secretary announced a number of insolvency-related measures to help protect viable companies affected by the pandemic, and to “remove the threat of personal liability” from directors in periods during which a company’s ability to continue as a going concern may be doubtful.

The measures that will be put in place are wide-ranging, and include:

- a moratorium for financially distressed, but ultimately viable, companies to prevent creditors taking action for a specified period without leave of the Court;

- a prohibition (subject to some exceptions) on the termination of goods and services contracts by reason of the company entering into an insolvency procedure;
- a new “Restructuring Plan”, similar in form to a Scheme of Arrangement, but also giving the ability to bind classes of creditors and members who have not approved it;
- restrictions on the circumstances in which winding-up petitions may be presented; and
- amendments to the wrongful trading provisions contained in the Insolvency Act 1986.

There are a number of important exclusions from the moratorium and wrongful trading provisions: in particular, they will not apply to parties to certain capital market arrangements and, in the case of the wrongful trading provisions, directors of those companies. Such exclusions (which could be particularly problematic for companies with listed securities) may be subject to amendment during the passage of the legislation.

This Client Update focuses on the position of directors in light of the amendments to the wrongful trading provisions.

Wrongful Trading Provisions

Many directors would have been relieved by the prospect of a temporary suspension of the wrongful trading provisions contained in Sections 214 and 246ZB of the Insolvency Act 1986. Those provisions, read together, impose liability on a director of a company in liquidation or administration for failing to take all steps possible to minimise the potential loss to the company’s creditors in circumstances where the director knew or ought to have known that there was “*no reasonable prospect that the company would avoid going into insolvent liquidation [or insolvent administration]*”. The legislation provides that references to insolvency in this context are to balance-sheet (i.e., not cash-flow) insolvency. The consequence of such a finding is a declaration that the director be liable to make such contribution to the company’s assets as the Court thinks proper.

At the time of the government’s announcement, it was not entirely clear how such a temporary suspension would be effected, although the government said that it would operate retrospectively from 1 March 2020 for three months. It was subsequently announced that the suspension would last until 30 June 2020.

The Draft Bill

Since 28 March, therefore, directors have not been entirely clear as to the scope of the UK's wrongful trading laws that were (in effect) already applicable to them. The position became somewhat clearer on 20 May, when the government published the Corporate Insolvency and Governance Bill (the "Bill"), now expected to be fast-tracked through Parliament in early June. Section 10 of this wide-ranging Bill provides that, in determining the contribution to be made by a director to a company's assets, where that director otherwise fulfils the criteria that permit the Court to make a declaration, the Court is to make the assumption that the person *"is not responsible for any worsening of the financial position of the company or its creditors that occurs during the relevant period."* The relevant period for these purposes runs from 1 March 2020 to 30 June 2020, or one month after entry into force of the Act, whichever is later.

Some questions will no doubt be raised as to the mechanism used by the government to "suspend liability". First and foremost, it is unclear how the proposed amendment operates to "suspend liability" at all. The effect of the legislation in its current form would still permit the Court to declare that a director be liable to make a contribution, albeit with a reduction to the amount of that contribution by virtue of the assumption in the director's favour.

There are further issues with the Bill, which may be subject to scrutiny during the Parliamentary approval process. For example, there is no requirement to show that the worsening financial position for which the director is not to be held responsible was attributable to the COVID-19 pandemic. Indeed, it would appear that the Court is obliged to make that assumption in favour of the director even if the director *did* contribute to the worsening of the company's financial position and that was entirely unrelated to the COVID-19 pandemic. In addition, the relevant period is (at least initially) quite short: according to the draft legislation, it will end in early July (one month after the law is in force) and directors will not benefit from the assumption in relation to any worsening of the company's financial position after that date. There is a power for the government to extend the period for up to six months, and it seems quite likely that there will be an extension, but that cannot be guaranteed.

Therefore, although the measure should provide some comfort to those responsible for making decisions about the viability of their business during these exceptional times, that comfort for directors will, perhaps, be limited. In addition, directors should be aware that other, similar, provisions attracting both civil and criminal liability continue to apply. As the Business Secretary cautioned, *"All of the other checks and balances that help to ensure directors fulfil their duties properly will remain in force."* The remainder of this note considers those other duties.

Creditors' Interest Duty

The common law duty of directors to give consideration to the interests of creditors when a company is in the zone of insolvency was preserved by Section 172(3) of the Companies Act 2006 and remains in full force. It is important to note that a director could breach the creditors' interest requirements more easily than the wrongful trading rules for two reasons.

- First, the current state of the law is that the creditor's interest duty is engaged when a director knows or ought to know that the company "*is or is likely to become insolvent*".¹ This formulation of the test is, however, under appeal to the Supreme Court, with the appellants arguing that the duty may be triggered more easily, where there is a "*real, as opposed to a remote, risk of insolvency*."²
- Second, the creditors' interest duty is engaged where a company becomes insolvent on either a cash-flow or balance-sheet basis.

In addition, the Bill does not impact other duties owed by directors under the Companies Act 2006, including those to act within their powers, to exercise independent judgement, to avoid conflicts of interest and to exercise reasonable care, skill and diligence.

Fraudulent Trading

The wrongful trading provisions are often considered alongside the fraudulent trading provisions set out at Sections 213 and 246ZA of the Insolvency Act 1986. The fraudulent trading provisions have not been suspended and apply where, in the course of the winding up of a company, it appears that the business of the company has been carried on with the "*intent to defraud creditors... or for any fraudulent purpose*." As with wrongful trading, the Court may order that such contributions be made to the company's assets as the Court thinks proper.

The distinction is that fraudulent trading also attracts criminal liability which is triggered whether or not the company is wound up, and is punishable by imprisonment or a fine. This provision generally requires dishonesty, and so honest and diligent directors may regard liability for fraudulent trading as somewhat remote.

¹ *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112

² [Link to Debevoise client update on CoA decision](#)

Transactions and Preferences

Also still in force are the provisions relating to transactions at an undervalue, set out in Section 238 of the Insolvency Act 1986. These provisions are triggered where, during the “relevant time” prior to a company entering into administration or liquidation, a company makes a gift or otherwise enters into a transaction for significantly lower consideration in circumstances where the transaction is not carried out in good faith and there are no reasonable grounds for believing the transaction would benefit the company.

Similarly, Section 239 of the Insolvency Act 1986 applies in the case of a company giving a “preference” to any person during the “relevant time”. For these purposes, a company gives a preference if it does anything which has the effect of putting a creditor into a more beneficial position than it otherwise would have been if a company goes into insolvency. Such a finding requires intent on the part of the company.

In both circumstances, the remedy is “*such order as [the court] thinks fit for restoring the position to what would have been [but for entry into the transaction or giving of the preference].*” Examples of such relief include an order that property be transferred back to the company, an order for release or discharge of security given by the company, or an order requiring any person to pay such sums as the Court may direct. It is easy to see how an order to pay sums could be made against a director involved in such a transaction.

In a similar vein, the provisions relating to transactions defrauding creditors set out at Section 423 Insolvency Act 1986 continue to apply, allowing the Court to order relief where a transaction takes place at an undervalue or the company makes a gift with the purpose of putting assets beyond the reach of potential creditors, or otherwise prejudicing their interests. The purpose of that relief is two-fold: (1) to restore the position to what it would have been but for the transaction, and (2) to protect the interests of persons who are victims of the transaction.

Whilst the relief ordered by the Court in such cases may well be primarily against the company, a director’s decision to enter into such a transaction (or give such a preference) clearly has the potential to give rise to a claim for breach of duty by a director, under the Companies Act 2006. Directors may also face disqualification under the Companies Directors Disqualification Act 1986.

Transaction Avoidance

Directors of companies in respect of which a winding-petition has already been presented should also bear in mind the transaction avoidance provisions of Section 127 of the Insolvency Act 1986, even if the winding-up process has been adjourned. The effect of that section is, broadly, that any disposition of the company's property, any transfer of shares, or any alteration to the company's members, made after presentation of the winding-up petition is automatically void (and therefore recoverable by the liquidator).

In such cases, an application for a Section 127 validation order may be necessary so as to allow certain transactions to proceed, where there is evidence that the transaction is of benefit to the company and will not prejudice the interests of the company's unsecured creditors.

Key Takeaways

The potential personal liability faced by directors of businesses continuing to trade during such uncertain times may, at first glance, seem overwhelming. The "suspension of liability" under the wrongful trading provisions will go some way to alleviate that although, in view of the time-limited nature of the suspension and the way in which it has been given effect, directors must remain mindful of these provisions and also of the requirements to observe their other duties.

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Please do not hesitate to contact us with any questions.

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