“Sometimes knowing what to do is knowing when to stop”: *wrongful trading and COVID-19*

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Richard Fisher QC and Roseanna Darcy consider the "suspension" of wrongful trading provisions introduced in the Corporate Insolvency and Governance Act ("CIGA") as one of the temporary measures aimed at avoiding and reducing insolvencies of companies that would have otherwise been viable but for the impact of COVID-19.

Introduction

It is not an easy time to be the director of a limited liability company. Business for many companies is tough, and directors should be considering how they can best fulfil their duties to the company and those interested in it.

English law seeks to regulate the conduct of directors in the twilight period before formal insolvency intervenes through a number of different tools. The principal provision of relevance for current purposes is that of "wrongful trading". Under the Insolvency Act 1986 (the "Act"), directors of a company that has entered insolvent liquidation or administration can be ordered to make a contribution to the company's assets if, at some time before the commencement of the relevant process, they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration, and failed to take every step with a view to minimising the potential loss to the company's creditors. Failing to minimise such losses and causing a worsening of the company's financial position is what is known as "wrongful trading".

However, wrongful trading is not the only provision that is relevant. Directors must also be mindful of the common law duty (retained through Section 172(3) Companies Act 2006) to have regard to the interests of creditors from the point at which a director knew or should have known that the company was or was likely (in the sense of probable) to become insolvent: *BTI v Sequana* [2019] EWA Civ 112. Once insolvent, the interests of the creditors are paramount (*ibid* at [222]).

Equally, directors need to be aware of the risk posed by Sections 213 and 246ZA of the Act. Causing a company to carry on business with intent to defraud creditors, or for any fraudulent purpose, will amount to fraudulent trading. Whilst most directors will dismiss out of hand the suggestion that they might be engaged in fraudulent trading, some caution is needed. It is correct that Sections 213 and 246ZA require evidence of actual dishonesty. But that requirement can be satisfied if there was reckless indifference to whether creditors are being defrauded (*Bernasconi v Nicholas Bennett & Co* [2000] BCC 921) and, most importantly, it has been held that there is a sufficient intent to defraud for these purposes if credit is obtained at a time when the person knows that there is no good reason for thinking that funds will become available to pay the debt when it becomes due or shortly thereafter (*R v Grantham* [1984] QB 675). Faced with the crisis posed by COVID-19, and the desire to keep businesses trading for as long as possible until immediate impact of the lockdown has passed, the risk that credit will be incurred in circumstances where it cannot be justified is likely to have increased. As observed in *Lightman & Moss* 6th ed. at [2-010] and [2-013]:

"the real problem posed for management by the fraudulent trading rules is how far and how long the company can continue to incur credit when the directors realise that the outcome of future trading is uncertain and that there is a real risk that things may not improve so that creditors may not be paid. ... It is at least theoretically possible, albeit unlikely in practice, for a director to incur liability for fraudulent trading in circumstances where he would not be liable for wrongful trading. This could happen where a director had a legitimate expectation that his company would escape liquidation through some form of restructuring but meanwhile caused the company to incur new debts that he knew would not be paid in full."

The protection for creditors created by these provisions, along with those that enable transactions prejudicing creditors to be challenged, and the provisions in the companies legislation that prevent capital from being returned to shareholders or dividends paid in certain circumstances, offsets the risk inherent in conducting business with a limited liability entity. Directors' conduct in the period before formal insolvency intervenes is regulated by the need to take into account the requirements of these provisions, and the risk of liability being imposed (or disqualification proceedings being brought) in due course. There are notably few successful cases of wrongful or fraudulent trading claims being brought: but the principal power of the provisions is in the way that they regulate the conduct of directors (and the advice given to those directors) in the period before formal insolvency proceedings intervene.

The COVID-19 pandemic has had a terrible and painful impact on individuals and society at large. The lock-down has in turn had a very serious impact on the economy. Faced with a potentially disastrous drop in business, many directors have looked to the Government for a response as to how they can balance the need to comply with obligations imposed by existing law with the need to try and keep companies afloat whilst the impact of the pandemic is assessed.

The response has been to focus on the wrongful trading provisions (and only the wrongful trading provisions) in order to try and give comfort to directors. But is this enough to provide comfort to directors?

What is the Government trying to achieve?

The Government first announced that they would be suspending the wrongful trading regime on 28 March 2020, the purpose being "*to give company directors greater confidence to use their best endeavours to continue to trade during*

the pandemic emergency without the threat of personal liability should the company ultimately fall into insolvency."

The explanatory notes accompanying the Corporate Insolvency and Governance Bill ("CIGB") as introduced in the House of Commons on 20 May 2020 explain the introduction of the relevant provisions on the following basis:

27: *The current crisis caused by the COVID-19 pandemic means that there is a great deal of uncertainty around trading conditions, both in the immediate and longer term future. Directors are having to make decisions about the future viability of their companies and whether it is appropriate for trading to continue.*

...

30 The objective of this measure is to remove the deterrent of a possible future wrongful trading application so that directors of companies which are impacted by the pandemic may make decisions about the future of the company without the threat of becoming liable to personally contribute to the company's assets if it later goes into liquidation or administration. This will in turn help to prevent businesses, which would be viable but for he impact of the pandemic, from closing."

They continue by describing the proposed legislation as a "*suspension of liability for wrongful trading*" (see paragraph 223 onwards of the explanatory notes), which is to be achieved by altering how the relevant sections of the Act will be applied in relation to the company's financial position during the relevant period.

What changes are being made?

Relatively few. There is no amendment of the provisions relating to wrongful trading in the Act. Whilst Section 12 of the CIGA is titled "Suspension of liability for wrongful trading: Great Britain", what is in fact being introduced is a form of retrospective legislative assumption in the following terms:

"In determining for the purposes of section 214 or 246ZB of the Insolvency Act 1986 (liability of director for wrongful trading), the contribution (if any) to a company's assets that it is proper for a person to make, the court is to assume 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 being defined in Section 12(2) of the CIGA).

The jurisdiction to make a declaration by reason of Section 214(2) or 246ZA(2) being satisfied (i.e. because the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation or administration) is not altered. However, the Court is required to assume that *"any worsening of the financial position of the company or its creditors that occurs during the relevant period"* is not something for which the relevant director is responsible. The effect therefore is that a director ought to avoid financial liability for any wrongful trading that occurred during the relevant period, even if the requirements of Sections 214(2) or 246ZA(2) are satisfied.

There are express limitations on the effect of Section 12. In particular, the assumption provided for by Section 12(1) does not apply if any point of time during the relevant period the company concerned was excluded from being eligible by reason of falling within any of the paragraphs of Schedule ZA1 to the Act listed in Section 12(4) of the CIGA (which include insurance companies, banks, electronic money institutions and (notably) parties to capital market arrangements). For directors acting in respect of companies conducting complicated business of this type, Section 12 is therefore irrelevant. One can understand why, politically, the directors of these companies may not be the most attractive targets to seek to assist. But they are involved in businesses where assessing the risk of wrongful trading may be particularly difficult, and where the impact of a premature filing for insolvency proceedings would be likely to have a more significant impact.

Is Section 12 likely to achieve its intended purpose?

Having announced the intended "*suspension*" of wrongful trading, the effect of Section 12 is in large part retrospective. Anecdotal evidence would suggest that there has not been a wave of unnecessary or premature filings for administration or liquidation as a consequence of the pandemic and it may be that the proposed legislation (combined with the furlough scheme) has given directors the comfort that they required. Section 12 of the CIGA ought to be effective to prevent wrongful trading claims being made in respect of the "*relevant period*". Two

points are worthy of emphasis in terms of the approach adopted.

First, the nature of the assumption that the Court is required to make. The drafting of Section 12 does not make clear whether the assumption is intended to be rebuttable if there is evidence that the director is responsible for a worsening of the financial position of the company during the relevant period. However, it would appear that this is not the case, and that the Court is required to apply the assumption whatever the underlying reason for the deterioration of the company's position during the relevant period. An amendment clarifying this point was proposed as the Bill moved through the House of Lords by Lord Hope. The House of Lords' Select Committee suggested that *"[c]reditors should not be precluded from taking legal action against directors for wrongful trading during that period if they can discharge any burden of proving that the instance of wrongful trading has no connection to financial distress induced by the pandemic".*

The Government's response of 19 June 2020 to the House of Lords' Select Committee's recommendations (the "Response") indicated that it would not be adopting or supporting any such modification, on the basis that:

"It would result in directors still facing the possibility of complex legal proceedings and the risk of personal liability if those proceedings were not resolved in their favour. Faced with that risk many directors may still adopt a precautionary approach and choose to close the company. If that was replicated across the economy it would result in significant additional loss of employment and damage to the economy as a whole."

Section 12 is therefore meant to operate (by way of assumption) as a bar on any claim being made for wrongful trading during the relevant period.

Secondly, Section 12 refers to an assumption regarding *"any worsening of the financial position of the company or its creditors that occurs during the relevant period"*. The jurisdiction to make a declaration to contribute where wrongful trading has occurred is framed in wide terms: *"such contribution (if any) to the company's assets as the court thinks proper"*. This has been interpreted as being limited to a compensatory jurisdiction, where any contribution is limited to the net deficit in the company's affairs caused during the period of wrongful trading: see, for example, *Re Produce Marketing Consortium Ltd* (1989) 5 BCC 569 at 597; *Re Ralls Builders Ltd* [2016] BCC 293 (an approach that has been the subject of significant criticism, in that it enables the payment of an old creditor at the expense of new creditors (robbing Peter to pay Paul) but without risk of wrongful trading liability if the net position of the company does not alter: see Moss [2017] 30 Insol Int 49).

However, whatever the rights and wrongs of that analysis, the language of Section 12(1) is wide enough to protect directors from any loss suffered by the company or particular creditors during the relevant period.

So far so good. But, as noted above, there are other provisions of the Act and common law that regulate the conduct of directors. They have not been altered by the CIGA. In fact, the Response has made clear that it is only wrongful trading liability that is its focus, stating:

"The temporary suspension of personal liability will not mean that directors will be able to avoid other protections afforded to creditors and the wider business community. Directors must continue to comply with their normal duties as clearly set out in the Companies Act, and various other remedies remain available where directors do not meet acceptable standards of behaviour. For example, fraudulent trading provisions provide both a civil recovery remedy as well as a criminal element where trading is continued with intent to defraud creditors. We believe that the provisions as drafted strike the right balance in responding to this extraordinary crisis."

So the Government's intention appears to be that potential personal liability for breach of duty, and fraudulent trading, is to continue without modification.

In practice, this may be more problematic, and rob directors of a large degree of the comfort that they thought that the suspension of wrongful trading was going to provide. It is unclear whether, and to what extent, the application of these other legal concepts can or should take into account the changes made to the wrongful trading regime. The Response suggests that those provisions continue as "*normal*" such that there is no attenuation of the standards to be applied to recognise the changes made by Section 12 during the relevant period. One cannot help but think that the Court will be slow to find a director liable for anything other than the most egregious and unjustifiable breaches of duty occurring during the pandemic period, or obvious fraudulent trading. Identifying conduct that is unreasonable and not in the best interests of creditors (and other stakeholders) is likely to be difficult against the exceptional background

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of the pandemic. But the purpose of introducing Section 12 was to give directors comfort so that they did not have to conduct a difficult balancing exercising and could operate with confidence. Why the alteration to the wrongful trading provisions is seen as the only change that needs to be made in order to give that confidence is unclear.

The problematic scenario may be along the lines of the "*theoretical*" risk identified in the passage cited from *Lightman & Moss* above, which risk has now become significantly more real than theoretical. Consider a company that is continuing to incur credit despite there being no reasonable prospect of avoiding insolvent administration or liquidation. The furlough system has been used to keep employees in a job despite it being probable that the company is or will become insolvent, and will have to enter a formal process when that support disappears. There is no good reason to think that things will get better and that funds will be available to meet the new credit being incurred. The company's (net) financial position has been worsened during this period. The problems for the company may have been caused principally by the pandemic but it also has underlying business difficulties.

If the Government wanted any decision on continued trading to be delayed until the impact of the pandemic was fully understood, it probably needed to introduce a more wider sweeping exemption from personal liability (perhaps with a rebuttable presumption to cater for cases of abuse). As it is, Section 12 seems to render the director immune from liability for wrongful trading. But it is not a universal panacea that avoids any other liability. The general duties of directors as set out in sections 171 to 177 of the Companies Act 2006 still apply. This means directors should have exercised reasonable care, skill and diligence, acted so as to promote the success of the company, and exercised independent judgment as well as acting in the best interests of creditors from the point when it was known, or should have been known, that the company was or was likely to become insolvent. Any such breach could still result in personal liability for directors. Similarly, the fraudulent trading regime means that directors should have been giving careful thought as to whether the company could meet any new liabilities that it incurred.

Conclusion

The "suspension" of wrongful trading combined with other steps taken by the Government may well have avoided precautionary formal insolvency filings as a result of the COVID-19 pandemic[1]. However, directors should respond cautiously and consider their position with care in light of their other duties. Whilst in the short term, the relaxation of this one form of potential personal liability may provide some much needed breathing space, it does not mean that directors are exempt from taking necessary steps to act in the best interests of the company, and importantly, in the best interests of creditors should insolvency appear to be on the cards.

Ultimately, it is not clear that removing the risk of liability for wrongful trading means the decision-making process for the director has been made (or should have been made) materially easier, or that a cautious director is less likely to put a company into a formal process just because one aspect of the risk of personal liability has been removed. As noted above, a particular area of concern may be the incurring of new creditors/the payment of existing creditors using funds borrowed from new creditors. The idea of "swapping creditors" may not necessary result in liability for directors under the usual wrongful trading rules if there is no increase in the net deficiency of the company (again see *Re Ralls Builders* where there was no net loss to the company or creditors in circumstances where continued trading allowed old creditors to be repaid despite new debts being incurred), but whether such actions could result in any particular case in an actionable preference or breach of duty (or even fraudulent trading claim) remains to be seen (as hinted at by the judge in *Re Ralls Builders* at [251]). Cases such as *In re Continental Assurance Co of London plc* [2007] 2 BCLC 287, as followed by Mr Justice Snowden in *Re Ralls Builders*, have made it clear that any defences under the wrongful trading provisions should not be used to provide a defence for directors for any preferential treatment given to some creditors, at the expense of others.

Directors' conduct during this exceptional period is likely to come under increased scrutiny as the pandemic ends, and the decisions made by directors can be assessed in the clear light of day. The relaxation of liability for wrongful trading does not avoid the need for a director to take care in considering whether a company really should continue to trade through this exceptional period. ■

1. Our government is not alone in taking such steps. Governments around the world have introduced measures to give some breathing space to directors with the aim of avoiding pre-emptive insolvency proceedings. In Germany, there is a temporary suspension of the duty to file for insolvency until 30 September 2020, removing the threat of criminal sanction against directors. Similarly, in France a company's legal representative will not be liable for a late filing for insolvency if cash flow insolvency occurs between 12 March 2020 and 23 August 2020. In Australia a six-month moratorium on insolvency trading liability for directors in respect of debts incurred "in the ordinary course of business" has been introduced, and in Singapore, the Covid-19 (Temporary Measures) Act also suspends wrongful trading rules as long as debts incurred by directors are done so "in the ordinary course of business". This list of measures is by no means exhaustive. How successful they will be remains to be seen.