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COVID-19
ASSISTANCE HUB

Corporate insolvency. Relax?

The government's relaxation of wrongful trading rules.

This weekend past, Business Secretary Alok Sharma announced that wrongful trading rules are to be relaxed to remove the threat of personal liability for company directors so they can focus on keeping their business going. The relaxation will apply retrospectively for three months from 1 March 2020, meaning that a third of the period has already lapsed. With two months to go, what waits on the horizon for company directors?

Where a company is in good health, Section 172(1) of the Companies Act 2006 imposes a duty on a company's directors to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

In times of trouble, however, the emphasis can shift from that of acting in the best interests of a company's shareholders to protecting the company's creditors. If the directors continue to trade in circumstances where they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation then they may be personally liable for wrongful trading under Section 214 of the Insolvency Act 1986. The court may then make a declaration for the directors to contribute to the company's assets during its winding up or administration, to the benefit of the company's creditors.

In practice this would mean, for example, that, where a company running a shop that became unable to pay its rent (and thus would have no real prospect of avoiding an insolvent liquidation on the presentation of a petition presented by the landlord), if the company were to continue to trade (e.g. by paying suppliers), its directors could be made personally liable for all the debts of the insolvent company. The landlord in this hypothetical example could enforce liability, not only for rent that had already fallen due, but potentially rent for the rest of the term of the lease (at least until the landlord were able to let it again at an equivalent rent) against the directors' personal assets, including their family homes.

It is these rules on personal liability for trading while insolvent that are to be relaxed during the COVID-19 pandemic. The government intends their temporary suspension to give company directors "greater confidence to use their best endeavours to continue to trade during this pandemic emergency, without the threat of personal liability should the company ultimately fall into insolvency."

While the government is yet to publish its legislation, and the precise changes to the wrongful trading rules are therefore unknown (an article on these rules will follow when this is published), the government spokesperson was clear that this temporary relaxation is not intended to undermine the duties of a company's directors to the company or permit the directors to act improperly.

Precisely where the line will be drawn is likely to be a matter of great difficulty, as either company directors of questionable probity, creditors desperate to be able to enforce against the personal assets of directors or both will seek to exploit any imprecision or unintended consequence in any rules defining the exact scope of the relaxation. In all probability, the government's proposed shield will apply where a company traded insolvently at a time when its directors were attempting to save the company—or where the directors were using their 'best endeavours to continue to trade', to quote the government spokesperson, for example, when restructuring. A version of the existing Section 214(3) test may therefore be something applied to company liquidations and administrations in the coming months: that the court shall not make a declaration of personal liability if the director took every step he or she ought to have taken—albeit the steps he or she took were in pursuit of enabling the company to continue to trade, rather than for the benefit of the company's creditors.

Whatever wording the government ultimately adopts in the legislation, one anticipates that the courts will soon be called on to determine whether a director's conduct during the COVID-19 crisis was such that they should avoid personal liability where that conduct increased a creditor's losses.

It seems unlikely that the rules on *fraudulent* trading under Section 213 of the Insolvency Act 1986 will be relaxed. This section provides that, if in the course of winding up (or administering: Section 246ZA of the 1986 Act) a company, it appears that any business of the company has been carried on with intent to defraud, *inter alia,* creditors, the directors may be made personally liable for the company's debts. This rule is rarely invoked as most cases of fraudulent trading are also cases of wrongful trading, which is easier to prove, as actual dishonesty is required for fraudulent trading: *In Re Patrick and Lyon Limited* [1933] Ch. 786. However, the provisions on fraudulent trading might become much more important during the suspension period as wrongful trading ceases to become available in at least some cases where it has hitherto been available.

Act with prudence despite the relaxation of the rules

At present, one can only speculate as to how the suspension of the wrongful trading rules will work in practice. However, what is clear is that on 1 June 2020 the suspension will lift (unless things change further). On our present understanding, the actions of a director that were lawful on 31 May 2020 may therefore be unlawful if taken the next day. As such, directors must remain cognisant of the ordinary duty even during this period of relaxation, to ensure they are ready for the resumption of the wrongful trading rules.

Further, until the precise scope of the abatement of the rules becomes known, one cannot safely assume that any given activity or trade will attract protection from personal liability for wrongful trading. Directors are likely, between now and the date of the publication of the actual rules (and to an extent thereafter until Parliament actually approves the legislation), to face difficult choices as to whether to proceed in light of an unknown risk that any given act will fall within the yet to be announced scope or not, and the competing risk that failing to do so might lead to other dire consequences for the business.

The following advice may prove helpful for businesses facing possible insolvency at this time.

- Decisions should still be made by directors on the basis of up to date and reliable financial information.
    - Given the difficulty that companies may have projecting their revenue at present, cautiousness is recommended, particularly when determining solvency.
- Regular (virtual) board meetings should be held to agree the measures to be taken by the company, and all decisions should be properly minuted.
    - The company articles may need to be amended to allow for meetings other than in person.
- If a director disagrees with a board decision, he/she should note his/her concerns in the minutes and/or communicate them clearly in writing to the board.
    - Resignation from office does not in itself avoid a director's liability for any wrongful trading occurring during that person's time in office. However, a proper paper trail of the decision-making processes may provide some insulation.
- Commercial financing or government grants should be applied for on the reasonable expectation that the funding will enable the company to survive the current crisis and continue on a 'business as usual' basis when wrongful trading rules resume.
    - It is important to check carefully whether and to what extent that funding is available in the particular circumstances before acting in reliance on such funding.
    - Seeking funding in the knowledge that it will not help the company to survive may amount to fraudulent trading or other unlawful misconduct.
- Any payments made should be carefully considered to ensure that they are essential to the continuity of the business and that no creditor receives preferential treatment (as any such preference, e.g., to pay a supplier but not the landlord, can be reversed under Section 239 of the Insolvency Act 1986).
    - Directors should also not pay company shareholders (e.g. by paying a dividend) without first considering the impact of any such payment on its creditors' prospects of being paid.

At the forefront of a director's mind if facing insolvency should be the question of whether there be a reasonable prospect that an action they take may avoid the company's insolvent liquidation. If there is not, the action is perhaps best avoided.

Directors should also bear in mind that it is only the wrongful trading rules that are being suspended. If a business carries on trading with the intent to defraud its creditors, severe criminal and civil penalties for fraudulent trading can still be imposed. Likewise, trading by preferring one creditor over another in circumstances where insolvency subsequently occurs, such as preferring a supplier over a landlord, although not a criminal matter, can result in the preference being reversed. Suppliers too should be aware of this.

Keep your company's solvency under review and act accordingly
Under the Insolvency Act 1986, a company will be considered insolvent if it fails either or both of two tests for insolvency: the cash flow test or the balance sheet test.

- A business fails the *cash flow test* if it is unable to pay its debts as they fall due.
- A business fails the *balance sheet test* if, looking at the company's assets and making proper allowance for its prospective and contingent liabilities, the court is satisfied that the value of the company's assets is less than the amount of its liabilities.

The balance sheet test is the basis of a finding of wrongful trading. However, the cash flow test remains relevant. This is because a company will be likely to have a lower valuation if forced to seek a buyer after a creditor petitions to wind the company up for failing to pay its debts (in accordance with the cash flow test). A lower valuation of the company and its assets may then lead the company to fail the balance sheet test and result in director liability for wrongful trading.

While the relaxation of wrongful trading rules may temporarily protect directors or limit their liability for trading while insolvent, reckless ignorance, action or inaction may still have legal consequences. Directors can still be liable to the company for breaches of their fiduciary duties to the company (e.g. to act at all times in the company's best interests, rather than their own personal best interests, which will not be the same even when the director is the only shareholder if the company has insufficient assets to meet its liabilities to creditors), and the government has made clear that the relaxation is not intended to release directors from this sort of duty. The government has warned that director disqualification, for example, will continue as a deterrent against director misconduct during its suspension of the wrongful trading rules. Furthermore, personal liability will return when the suspension is lifted in two months' time, meaning that directors need to remain alert to the possibility that they may be trading while insolvent at that time. The precise cut-off date may be of critical importance.

Review your actions well in advance of 1 June 2020
Quite the scope of the temporary suspension of the wrongful trading rules and how the transition to the resumption of the rule in its full rigour will be handled is difficult to predict. More detail will be given here when the rules are announced and, in due course, changed as they may very well be, multiple times. However, in practice, it may prove difficult to work out in advance when a court would in some hypothetical future insolvency litigation determine that a risk of insolvency had become sufficiently real for wrongful trading rules

(either the normal provisions or whatever is left of the rule when the normal rules are suspended) to become engaged and which of a number of related actions was ultimately against the interests of a company's creditors. This is likely to make it highly complex to determine in all but simple cases what action(s) are likely to give rise to personal liability on the part of directors and which are not, so caution is urged.

Falling the wrong side of the government's 1 June 2020 resumption date may have serious financial consequences for a director. Therefore, directors should take particular care to review and consider their own actions in the weeks leading up to 1 June 2020, if a risk of insolvency exists. As the date approaches, they may need to consider whether it remains appropriate for the company to continue trading at all.

Remaining alert to the risk of wrongful trading rules, despite their suspension, is essential for directors of companies facing insolvency. If procedures be in place to record how directors have used their 'best endeavours' to continue to trade during the pandemic, they may be able to show that, in so acting, they were protecting their creditors as well. This may help shield them from personal liability in the unfortunate event of their insolvent liquidation and whether the wrongful trading rules were suspended or not, although to what extent that this will assist remains to be seen when the actual draft legislation comes to be published.

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