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SUSPENSION OF WRONGFUL TRADING PROVISIONS

A lifeline or a noose?

By Cheryl Jones

What is wrongful trading and what are its consequences?

1. Wrongful trading takes place when one or more Directors knows or ought to have known that the Company had no reasonable prospect of avoiding going into administration or insolvent liquidation but continues to trade anyway, with the Company subsequently entering administration or insolvent liquidation [S214(2) & 246ZB Insolvency Act 1986]. The consequences for the Director can be swingeing, with orders against them personally to pay contributions reflecting the increase in insolvency during the period of wrongful trading, together with the never inconsiderable costs of the Insolvency Practitioner who brings the claim. The consequence of such orders is often the bankruptcy of the Director or Directors.

2. The Court will not make the order if, at the point when the Director knew (or ought to have known) that administration/insolvent liquidation was unavoidable, they took steps to minimise the potential losses to the creditors. That usually means they should seek advice from an Insolvency Practitioner about going into administration/liquidation.

3. Wrongful trading has been on the receiving end of justifiable criticism because, in the end, it is a question of judgment as to when a Company has no reasonable prospect of avoiding entering administration/insolvent liquidation, with that judgment being far easier for an Insolvency Practitioner making a retrospective analysis than for a Director in a fast-moving situation where the hope of rescue burns bright. Information presented and analysed in a dry and calculated manner at leisure after the event is very different from the piecemeal information tumbling through in no particular order to the pressurised Director or Directors of a Company which is clearly in trouble but for which there may be a prospect of a contract or payment which will turn things around, or a genuine hope of a sale or a white knight.

Why are there proposed changes now?

4. Well, the short answer is COVID-19. We are in a position where many Companies are being driven into a position whereby they cannot, in the short term, reasonably avoid administration or liquidation although they might be able to trade out of difficulties if they can weather the present storm. Even relatively strong Companies in some sectors (restaurants, for example) are likely to struggle with lack of cashflow whilst overheads remain relatively high. As things stand, the Directors of those Companies are personally at risk if they do not take the appropriate steps, despite the distant possibility or even probability of a brighter future.

5. The Government is anxious that Directors should not have to look over their shoulders and risk personal insolvency whilst trying to keep Companies going without hope of any income in the near future. If Directors can hold their nerve and allow an increase in liabilities in the short term, then at least some Companies which presently satisfy the definition of insolvency may survive and be able to continue upon the release of lockdown and renewed economic activities. If, in the longer run, there is no administration or liquidation, then the Directors will get away with having traded in the knowledge that the Company is actually insolvent. If, however, the Company does enter administration or liquidation in the future, then the Directors will have caused and allowed extra liabilities to accrue after what, in ordinary times, would be deemed the point of no return. Whilst s214 continues in force, therefore, Directors in these unusual times must act to minimise losses and cannot continue to trade in the hope of a turnaround if they are objectively insolvent now.

6. Whilst some might argue that courts will be reluctant to make findings of wrongful trading in a fast-changing environment, and that COVID-19 is unquestionably a unique challenge, the plain fact is that any Director remains firmly in the firing line and cannot be blamed for a reluctance to risk being the cutting edge of legal decision-making. The likelihood, therefore, is that without the comfort of legislation a large number of Companies who have a prospect of trading through insolvency on the lifting of the lockdown, but who on present information are insolvent, will be placed into administration or liquidation.

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What are the changes?

7. The Government has proposed that s214 & s246ZB should be suspended for a period of three months, backdated to 1st March 2020 but with the possibility of an extension beyond 31st May 2020 if considered necessary. During the operational period it is intended that, in the event that a Company enters administration or insolvent liquidation, a Director will not be held personally liable for failing to take steps to minimise potential losses.

8. There is also discussion of a separate stand-alone option of a moratorium during which no insolvency proceedings can be brought, to try to give time to trade out of temporary difficulties. There are no real details available of this option yet, but it is likely to resemble the Chapter 11 process in the United States.

So quite straightforward then?

9. Regrettably, it is not quite that simple. One should not expect it to be, given the complexities and consequences of an increase in debt and loss to creditors.

10. Firstly, these remain mere proposals with no statutory force. The Insolvency Act 1986 is primary legislation and any change or suspension can only be dealt with by way of an Act of Parliament. Parliament is not sitting at the moment and there is never any guarantee that a government can pass its intended legislation, although in these strange times it is unlikely that the relevant legislation would fail. Directors who are continuing to trade insolvently are hanging their hats on the intentions of the Government, which does not tend to have a great deal of force in the courts. Plain fact is that they are subject to s214 or 246ZB until and unless the legislation is enacted and the proposed backdating becomes law.

11. Secondly, the proposed legislation appears to be something of a blanket provision, attaching to any Company and Director for the relevant period, irrespective of whether or not the reason for the insolvency of the Company is linked to COVID-19, is pre-existing or arises for completely unrelated reasons after 1st March 2020.

12. It would be foolish for Directors of a Company already in trouble simply to assume that they will get a free pass because of the suspension from 1st March 2020. If the Company was obviously and objectively insolvent

before 1st March 2020, then there is nothing to stop a claim being brought for a contribution relating to the period prior to 1st March 2020. In addition, it is possible, depending on the wording of the legislation, that if Directors were trading wrongfully before 1st March 2020 they may be unable to claim the benefit of the suspension after 1st March 2020. One can certainly anticipate a certain amount of fine-tooth combing of the legislation to see if additional claims are a possibility. It would seem contradictory for a Director to be liable on 29th February 2020 on the grounds that the Company should already be in administration or liquidation, and then be relieved of responsibility for the next three months.

13. Any unrelated insolvency becoming apparent after 1st March 2020 is likely to be bleached out by the proposed legislation. To be fair, it would be extremely difficult to ascertain whether a Company has become insolvent because of COVID-19 or for unrelated reasons, because the whole economic landscape is so tainted by the pandemic. There seems little likelihood that any Insolvency Practitioner would take the financial risk of trying to get around the suspension where a Company was viable on 1st March 2020, even if the wording of the legislation was sufficiently loose to allow for the possibility, because of the obvious difficulty of proving in the current climate that a Company became insolvent for any other reason.

14. Thirdly, the only provision which is suspended is wrongful trading. Claims in misfeasance [s212], preferences [s239] and transactions at an undervalue [s238] remain in force so that, for example, a Director who sells a property at a low price in order to keep paying important suppliers might be faced with a claim under s238 or s239; or a Director who pays herself dividends to keep afloat, or increases her Director's loan, may face misfeasance claims.

15. In addition, fraudulent trading remains in place [s213] with its wider compass. It may be that this section could be used where it was clear before 1st March 2020 that a Company was unlikely to avoid administration or insolvent liquidation, but the Directors kept it trading after 1st March 2020 on the basis that they could take advantage of the suspension of s214/s246ZB.

Conclusion

16. In conclusion, therefore, whilst the suspension of s214/s246ZB is a

welcome assistance to Directors struggling to keep Companies afloat in the expectation, or even mere hope, that things will turn around in the summer, it cannot and must not be treated as a “Get out of Jail Free” card. There are still a number of claims which can be brought in cases where Insolvency Practitioners take the view that a Director has fallen foul of the remaining parts of the Insolvency Act 1986.

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