SUSPENSION OF WRONGFUL TRADING IN LIGHT OF COVID-19

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DIRECTORS' PERSONAL LIABILITY FOR WRONGFUL TRADING – RELIEF DURING THE CORONAVIRUS CRISIS

As the UK's economy continues to experience shocks, and companies of all sizes face increasingly intense financial pressure as a result of the coronavirus pandemic, the Department for Business, Energy and Industrial Strategy has announced plans to suspend provisions relating to wrongful trading under the UK Insolvency Act 1986 (the "Act"). The suspension is designed to ease the pressure on directors running their businesses whilst technically insolvent by removing the spectre of personal liability. However, other penalties do remain for directors who continue to trade to the detriment of creditors.

WHAT IS WRONGFUL TRADING?

The rules relating to wrongful trading are set out in sections 214 (in relation to the winding up of a company) and 246ZB (in respect of administration of a company) of the Act. Those provisions give the court the power to make a declaration that a person who is (or has been) the director of a company in the process of winding up or administration should make a contribution to the company's assets. In effect, wrongful trading can create personal liability for directors to make good losses sustained by creditors and, in some cases, shareholders. The risk of wrongful trading for directors arises where the company has continued to trade (and incurred liabilities) beyond the point at which its insolvency became inevitable and unavoidable.

A wrongful trading application is made by the company's liquidator/administrator. To sustain the application, the director must have had, at some point before the winding up or administration of the company, knowledge that there was no reasonable prospect that the company could avoid going into insolvent liquidation or administration. However, the director will have a defence if he/she can prove that, at the relevant time, they took every step available with a view to minimising the potential loss to the company's creditors.

Typically, the prospect of liability for wrongful trading emerges where a director continues to trade beyond the point at which they should have taken the decision to move the company towards liquidation or administration. This point may be difficult to identify in practice. However, it is usually the point at which there is no prospect of restructuring, new finance or some other transaction/assistance maintaining the business as a going concern. Personal liability is imposed on the basis that creditors, whose position has been worsened by the actions of the director, should be compensated.

TEMPORARY RELAXATION OF LIABILITY

The Government has announced that it will temporarily suspend the Act's wrongful trading provisions. The objective is to ensure that directors continue to trade for as long as possible despite the challenging market conditions, without threat of eventual liability for wrongful trading.

The legislation to make this change will be introduced "at the earliest opportunity", initially for a three-month period (which may be extended if necessary). The measures will have retrospective effect from 1 March 2020.

As yet, the specific statutory language to implement the change has not been published and so we await these details to see exactly how the relief will work.

OUR OBSERVATIONS

The suspension of wrongful trading liability follows other similar steps taken in other countries (for instance, Germany and Australia) to adjust insolvency law in the face of the unique challenges of the coronavirus pandemic.

Whilst welcomed in some quarters, support for the suspension of the rules has not been universal. In particular, R3, the Association of Business Recovery Professionals, made up of liquidators, administrators and other insolvency practitioners, has voiced its opposition to the move. It fears that the suspension may be abused.

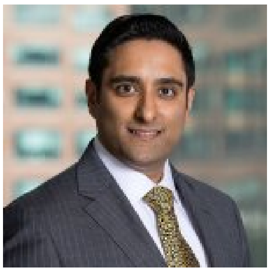
However, while the rules on wrongful trading will be suspended, directors need to remain wary of:

1. their continuing duties as directors under the Companies Act 2006, including to promote the success of the company and to exercise reasonable care, skill and diligence;
2. the potential for civil liability for fraudulent trading under sections 213 and 246ZA of the Act, and criminal liability under section 993 of the Companies Act 2006; and
3. potential disqualification under the Company Directors Disqualification Act 1986.

The risk of disqualification may be of particular significance. The test for disqualification is whether the relevant director is unfit to be involved in the management of a company, having engaged in 'unfit conduct'. This includes allowing a company to continue trading when it cannot pay its debts. We consider that the rules relating to directors' disqualification have been retained as a check against possible abuse of the suspension of the wrongful trading rules to the detriment of creditors.

With the announcement of the suspension of the wrongful trading rules, the Department for Business, Energy and Industrial Strategy has looked to give directors a freer hand to continue trading with reduced fears of personal liability. The Government hopes that, to the extent possible, companies can avoid insolvency or, at the very least, the decision to place a company into administration or liquidation will be deferred until the directors can seek to save their businesses by taking advantage of the other emergency legislative and economic support measures. Despite this, the continuing rules relating to directors' duties, and in particular the disqualification of directors, mean they should continue to consider their conduct carefully where their companies come under financial pressure during the ongoing pandemic. Directors should take legal advice to navigate these difficult and unprecedented times.

KEY CONTACTS



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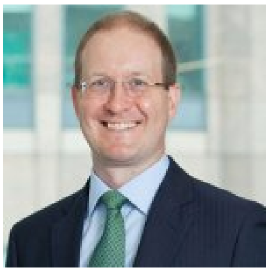

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