ENYO LAW

The Suspension of Wrongful Trading Provisions and Directors' Continuing Liabilities and Duties

By Meriel Hodgson-Teall and Daniel Mills of Enyo Law and Saaman Pourghadiri of Outer Temple Chambers

Wrongful trading provisions plus proposed suspension

Amongst a set of far-reaching new measures designed to ease the pressures and impact of the COVID-19 pandemic on UK businesses, the UK Government recently announced its intention to temporarily suspend provisions relating to wrongful trading by directors of UK companies. The measures, implemented by way of amendment to the UK Insolvency Act 1986 (the "**Insolvency Act**"), are intended to allow company directors to keep trading without the threat of personal liability while options to rescue or restructure struggling businesses are explored.

The stated purpose of the measures is 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*."

This article takes a closer look at the measures, as well as the risks and liabilities which remain for directors nonetheless.

Wrongful trading – an overview

When companies are solvent, directors are bound to act in accordance with the usual statutory and common law duties; for example to promote the success of the company, exercise reasonable care, skill and diligence, etc. These duties are owed to the company itself. However, when a company is (or is at risk of becoming) insolvent, the law prioritises the interests of creditors to ensure they are not left out-of-pocket, and increases the accountability of directors accordingly.

In an insolvency, administrators and liquidators are empowered to examine a company's performance with a view to identifying the underlying cause of the difficulty, and determining the point in time at which insolvent administration or liquidation became unavoidable. Section 214 of the Insolvency Act provides that if, at some point before the commencement of the winding up, it is determined that a director knew, or ought to have concluded, that there was no reasonable prospect of the company avoiding insolvent liquidation, and the company continued to incur liabilities nonetheless, the director may personally be liable to contribute to the assets of the company to the extent it is worse off as a result of such continued trading. Furthermore, directors found liable for wrongful trading may be subject to disqualification orders of up to 15 years.

Accordingly, directors are at risk of liability for wrongful trading in the period between (i) the point at which they knew, or ought to have known, that insolvency was unavoidable; and (ii) the commencement of liquidation or administration. Practically, the wrongful trading provisions are often the 'trigger' for directors to file for insolvency.

The March 2020 measures

On 28 March 2020, the Government announced, in broad terms, that it would retroactively suspend the wrongful trading provisions under section 214 in respect of actions taken after 1 March 2020 for an initial period of three months.

The move is a clear recognition of the strain placed on business by COVID-19 and its widespread societal impact, and is intended to safeguard companies through these difficult times. The novel and unprecedented nature of the situation combined with the continued uncertainty as to how the situation will develop over the coming months means that it is exceptionally difficult to make the sort of assessment required by section 214. In particular, insolvency well may be 'inevitable' for many businesses under the current circumstances which may otherwise be perfectly viable and able to continue operating once the various restrictions are lifted and the situation has calmed. In such circumstances, decisions on whether to continue trading become exceptionally difficult, and the cautious approach demanded by section 214 will force many otherwise-viable businesses into insolvency.

In this regard, by suspending the wrongful trading provisions, the measures will allow directors of companies to continue trading, and continue paying staff and suppliers in the usual way, even when they appear to be nearing insolvency.

However, this does not mean that directors faced with such decisions should act any differently from how they would (or should) have done pre-1 March 2020. When announcing the moratorium, the Business Secretary was keen to emphasise that all of the other checks and balances that help to ensure directors fulfil their duties properly will remain in force. For example, as explained below, the fraudulent trading provision under section 213 of the Insolvency Act remains in force, and directors remain bound to comply with their usual fiduciary duties.

Remaining risks and liabilities under the Insolvency Act

Directors of companies which continue trading in circumstances where there is no reasonable prospect of avoiding an insolvent liquidation can still expose themselves to risks, however. Other provisions of the Insolvency Act still regulate directors' conduct and the threat of personal liability remains.

Misfeasance, breach of duties and liability to account: Section 212 of the Insolvency Act

There is no mention in the Government's recent announcements of suspending or amending the provisions relating to misfeasance and breach of duties under section 212 of the Insolvency Act.

Section 212 provides that past or present officers[1] of a company may be required to make a contribution to the company where in the course of a winding up there has been a misapplication of company money or other property of the company; misfeasance, or breach of any fiduciary or other duty. "*Other duty*" includes the duty of care, meaning that this provision includes claims based on negligence.[2] It could also be triggered where a director breaches his or her directors' duties under the Companies Act 2006.

This means that where a company continues trading in circumstances where there is no reasonable prospect of avoiding an insolvent liquidation, and if the directors breach their fiduciary or other duties in their management of the company, they may still be personally liable even though section 214 (wrongful trading) has been suspended.

Where a claim is brought against directors for negligence or breach of duty under this section 212, the director in question may be able to claim contribution from professional advisers on whose advice they acted, such as insolvency practitioners who had advised that they could continue trading before the company went into liquidation.[3]

In addition, Section 1157 of the Companies Act 2006 empowers the court, in any proceedings against an officer or auditor of a company for (*inter alia*) negligence, breach of duty or breach of trust, to relieve the defendant either wholly or partly from liability if he has acted honestly and reasonably, and ought to be, in the circumstances, fairly excused. In circumstances where directors have continued trading on professional advice, this has been used as a basis for escaping liability under section 212 of the Insolvency Act.[4]

Fraudulent trading: Section 213 of the Insolvency Act

Provisions regarding fraudulent trading under section 213 of the Insolvency Act also remain in full force and there is no talk of suspending these.

Section 213 of the Insolvency Act provides that if in the course of a winding up it appears that the business of a company has been carried on with intent to defraud creditors or for any other fraudulent purpose, any person who was knowingly a party to this conduct may be liable to make contributions to the company's assets.[5]

---

[1] The term officer is defined in section 251 of the Insolvency Act: "*officer, in relation to a body corporate, includes a director, manager or secretary*". This is a broad definition which would include *"[any] person who in the affairs of the company exercises a supervisory control which reflects the general policy of the company for the time being or which is related to the general administration of the company is in the sphere of management*." (*Re a Company (No.00996 of 1979)* [1980] Ch. 138 at 144.)

[2] *Re D'Jan of London Ltd* [1993] B.C.C. 646

[3] *Re International Championship Management Ltd* [2006] EWHC 768 (Ch)

[4] *Re Continental Assurance Co of London plc (No.4)* [2007] 2 B.C.L.C. 287

[5] Fraudulent trading is also a criminal offence under section 993 of the Companies Act 2006 and a person held liable in respect of fraudulent trading under section 213 of the Insolvency Act may also have a disqualification order made against them by the court under sections 4 and 10 of the Company Directors Disqualification Act 1986.

The key distinction between this provision and wrongful trading under section 214 is dishonesty: for fraudulent trading, it is not enough to show that the directors continued to run up debts when they knew the company was insolvent and that this was prejudicial to creditors; dishonesty must be proven. Whether conduct was dishonest is determined by reference to the objective standards of ordinary decent people.[6] One dishonest transaction could be enough to fall short of this provision[7] and it is not necessary to have full knowledge of the company's scheme to be held liable, provided the individual in question had knowledge of the carrying on of the company's business in such a way as to defraud creditors.[8]

The other provisions of the Insolvency Act to be aware of

In addition, past and present directors will be guilty of an offence under the Insolvency Act if they have committed any of the following:

- Fraud (including concealing or removing property, falsifying entries in the company's books and other similar acts, with intent to defraud) in anticipation of winding up (s. 206)
- Transactions with intent to defraud creditors (s. 207)
- Misconduct in the course of winding up by providing inaccurate information to the liquidator (s. 208)
- Falsification of company's books (s. 209)
- Material omissions from statements relating to company's affairs with intent to defraud (s. 210)
- False representations to creditors (s. 211)

The sanctions for these offences are severe: up to seven years' imprisonment, or a fine or both (Schedule 10 of the Insolvency Act).

Companies Act duties as Director

General duties

Similarly, directors will continue to be subject to all of the ordinary duties they owe to their company pursuant to the Companies Act 2006. The general duties will be familiar. They include:

- Duty to act in accordance with the company's constitution and to exercise powers only for the purposes for which they are conferred (s. 171)
- Duty to promote the success of the company (s. 172)
- Duty to exercise independent judgment (s. 173)
- Duty to exercise reasonable care, skill and diligence (s. 174)
- Duty to avoid conflicts of interest (s. 175)
- Duties to not accept benefits from third parties, and declare interests in any proposed transactions or arrangements (ss. 176-177)

Breach of each of these duties can leave a director vulnerable to claims by the company for damages, a reversal of transactions between directors and the company and/or claims to disgorge any benefit the director has obtained from their breach.

As set out above, if a company enters into insolvency then the insolvency practitioner can bring a claim for breach of these duties pursuant to section 212 of the Insolvency Act.

---

[6] *Pantiles Investments Ltd (in liq.) v Winckler* [2019] EWHC 1298 (Ch)
[7] *Re Gerald Cooper Chemicals Ltd (in liq.)* [1978] Ch. 262
[8] *Pantiles Investments*

Interests of Creditors

In the current context it is worth bearing in mind that when exercising their duties, directors can owe a duty to take the interests of creditors into account. The duty to take the interests of creditors into account is triggered when the company is insolvent or the directors know or ought to know the company is "*likely*" to become insolvent i.e. it is probable that the company will enter insolvency.[9] This is a higher threshold than a "*real risk*", but a lower threshold than certainty. Once that threshold is reached, the interests of creditors are "*paramount*".[10]

Importantly, insolvency means either cash-flow or balance sheet insolvency.[11] Given the enormous cash-flow constraints many businesses are suffering from, many companies with strong balance sheets may well become technically insolvent. Unless the Government plans to address this issue alongside its suspension of the wrongful trading provisions, directors continue to face the risk of personal liability if their efforts to trade through the cash-flow crunch caused by the pandemic are unsuccessful such that they cause their company's balance sheet to deteriorate further.

Ordinarily, a director's duty pursuant to section 172 of the Company Act to promote the interests of the company merely imposes a subjective standard and not a higher objective standard i.e. so long as a director honestly believes their actions will promote the success of the company, they will not be in breach of their duties on the grounds that objectively a "*reasonable director*" would have concluded differently.[12] However, where a company is likely to become insolvent, a director's failure to take into account the interests of creditors when making decisions will be judged against the higher objective standard.[13] It is therefore important to ensure decision making is documented and evidences the fact that a director of a company in distress has considered the interests of creditors, and that such interests were a "*paramount*" consideration in the director's decision making.

The no-conflicts rule and companies nearing insolvency

A director's duty to avoid conflicts of interest applies to the exploitation of any property information or opportunity and, as section 175(3) of the Companies Act makes explicit, it is immaterial whether the company could take advantage of the property, information or opportunity. The High Court has recently reaffirmed[14] that this prohibition applies even when a company cannot take advantage of a business opportunity because it is nearing insolvency and the directors would be exposed to the risk of a wrongful trading claim if they caused the company to pursue the business opportunity.

Thus, unless a director has obtained authorisation, they must not breach the no-conflict rule, even where their companies' likely insolvency prevents it from taking advantage of a business opportunity.

Fraudulent trading

The Companies Act 2006 creates a criminal offence of fraudulent trading.[15] It mirrors the provisions for fraudulent trading at section 213 of the Insolvency Act, in that the test is whether the business has been carried on "*with intent to defraud creditors of the company*." Just as directors remain exposed to civil liability pursuant to section 213, they also remain exposed to criminal liability under this provision.

---

[9] *BTI v Sequana SA* [2019] 2 All E.R. 784, [220]

[10] *Colin Gwyer v London Wharf* [2003] BCC 885, [74]

[11] Section 123 of the Insolvency Act

[12] *Cobden v RWM Langport* [2008] EHWC 2810 (Ch), [53]

[13] *Hellard v Carvalho* [2013] EWHC 2876 (Ch), [92(c)]

[14] *Davies v Ford* [2020] EWHC 686 (Ch) [284] – [289]

[15] Section 993 of the Companies Act

Conclusion

The suspension of the wrongful trading provisions will be welcomed by directors. However, it is not a panacea. Directors still risk personal liability for decisions made during this crisis.

Directors of companies which are finding themselves in financial difficulty as a result of the current economic climate and the impact of COVID-19 should:

- Brush up on directors' duties
- Seek the advice of insolvency practitioners early
- Keep accurate records
- Make sure any transactions which are not in the ordinary course of business are properly scrutinised before they are entered into and consider how these transactions will affect the company's creditors
- If it comes to a liquidation, provide complete and accurate records to the liquidator.

Note that Parliament returned from recess on 21 April 2020, and further detail is awaited.