Directors' liability and the Corporate Insolvency and Governance Act 2020

Wrongful trading rules give creditors a route to recoup some of their losses from the pockets of directors who unreasonably tried to trade a company out of insolvency. But even the directors of perfectly viable businesses could have feared insolvency was unavoidable in the extraordinary economic and social conditions brought on by the Coronavirus disease (Covid-19) pandemic. To keep such businesses alive in these conditions, the government introduced a package of measures in the Corporate Insolvency and Governance Act 2020 ("CIGA 2020") which came into force on 25 June, including a suspension of directors' liability for wrongful trading during the emergency period. Despite this gesture, however, there remain several routes by which directors who try unsuccessfully to trade out of insolvency can be held liable to swell the company's assets.

Wrongful trading: the default position

By s 214 Insolvency Act 1986 ("IA 1986") (wrongful trading), the court may order a director of a company in insolvent liquidation to contribute personally to the company's assets if the director "*knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation*" (s 214(2)(b)) unless, from this point onwards, the director "*took every step with a view to minimising the potential loss to the company's creditors as… he ought to have taken*" (s 214(3)).

Directors will be ordered to contribute if the company suffered loss caused by the period of wrongful trading: "*as a starting point this should be approached by asking whether there was an increase or reduction in the net deficiency of the company as regards unsecured creditors*" (*Grant v Ralls* [2016] EWHC 243 (Ch) at [241]). In addition, "*there has to be some causal connection between the amount of any contribution and the continuation of trading. Losses that would have been incurred in any event as a consequence of a company going into a formal insolvency process should not be laid at the door of directors under section 214.*" (*Grant*, above at [242]).

Suspension of wrongful trading liability: the effect of the 2020 Act

The new rules absolve directors from liability for losses caused by trading during the emergency period: section 12 of CIGA 2020 states that "*(1) 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 or 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 government's intention was that this "*assumption*" should be irrebuttable ((HL Hansard 9 June 2020 Vol 803 Col 1683 and 1727). The *"relevant period"* is defined by s 12(2) as 1 March 2020-30 September 2020.

Introducing the measure, Alok Sharma, Secretary of State for Business, Energy and Industrial Strategy, set out the government's policy aim of

encouraging the directors of viable businesses to continue to trade. "*This measure gives company directors the confidence to use their best efforts to continue trading without the threat of personal liability, should the company ultimately go into insolvency.*" (Hansard, 3 June 2020 Vol 676 Col 896).

Ongoing liability risks for directors and recovery routes for creditors

Directors should, however, be wary about throwing caution to the winds. In the Parliamentary debate that followed, the Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy (Paul Scully) acknowledged that "*although there will be a temporary suspension of wrongful trading liability, directors will still have legal duties under wider company law. Those duties will remain in place, as will measures under insolvency law to penalise directors who abuse their position*" (Hansard, 3 June 2020 Vol 676 col 950).

Where a company is near insolvency, the directors have a duty, preserved by s172(3) Companies Act ("CA") 2006, to consider and act in the interests of its creditors. This duty, which CIGA 2020 has not suspended, would appear to place the directors of near-insolvent companies under a similar obligation, of conducting the company's affairs in such a way as to minimise the loss to its creditors, to that in s 214 IA 1986 (the temporarily-suspended wrongful trading provision).

Although the CA 2006 duty is less strict in that it does not extend to "*taking every step*" in creditors' interests, and although there is some debate as to whether their interests are "*paramount*" or merely one factor (*BAT v Sequana* [2019] Bus LR 2178, [222]), it has a broader ambit than the s 214 wrongful trading duty. The wrongful trading duty only arises when there is "*no reasonable prospect*" of avoiding insolvency, but the CA 2006 duty arises when insolvency is merely probable (and the Supreme Court is due to consider whether the trigger for the duty is lower still, such that it arises when there is merely a "*real risk*" of insolvency) (*BAT*, above [220]-[221]).

The liquidator of an insolvent company can cause the company to sue the directors for breaches of duties such as these. At common law, they could be liable to pay damages or (in the case of the creditors' interests duty) provide other remedies applicable to breaches of fiduciary duties. Alternatively, any creditor can apply for a remedy under s 212 IA 1986, which has not been suspended, if "*if in the course of the winding up of a company it appears that*" a director has committed misfeasance or breach of duty. On such an application, the court may order the delinquent director to contribute to the company's assets. Hence, creditors could still rely on breaches of directors' duties to seek to circumvent the temporary protection afforded by s 12 CIGA 2020 and reclaim losses from directors who made the company's position worse by continuing to trade.

Directors of companies that become insolvent are also liable to disqualification under s 6 Company Directors Disqualification Act ("CDDA") 1986, if the court determines that their conduct as a director makes them "*unfit*" to be concerned in the management of a company. The court has a broad discretion as to whether it makes such a determination, but will take into account breaches of duty such as those referred to above. Indeed, trading while insolvent to the detriment of creditors is a typical form of misconduct that, at least in ordinary times, could lead to a finding of unfitness. If the conduct that led to disqualification caused loss to one or more creditors of the insolvent company, under ss 15A-15B CDDA 1986 the court can order the disqualified director to pay compensation for the benefit of any specific creditor or creditors, or as a contribution to the assets of the insolvent company. One of the aims of this regime is to give creditors additional recourse to the directors' personal funds beyond that available under IA 1986 (*Re Noble Vintners Ltd* [2019] EWHC 2806 (Ch), at [16]-[19]). However, applications under ss 6 and 15A-15B CDDA 1986 are the preserve of the Secretary of State / Official Receiver (s 7(1)), who might be expected to honour the government's policy of encouraging businesses to continue trading through the Coronavirus pandemic, by desisting from making such applications except in relation to really egregious misconduct during the emergency period. But these policy priorities could change: by s7(2), the limitation

period for applications under s 6 is three years from the date of insolvency (or longer with leave of the court) – which is a long time in politics.

The provisions in IA 1986 against fraudulent trading (s 213) are also unaffected by CIGA 2020. Thus, if a liquidator has sufficient evidence that any business of the company has been carried on with intent to defraud the company's creditors, the court may still order directors to contribute to its assets. Absent the new rules, the stricter legal principles that apply to claims under s 213 would act as a disincentive to bring such claims: the applicant must establish that the director(s) participated in the carrying on of the business "*with the knowledge that the transactions in which he participates are intended to defraud creditors or are in some other way fraudulent*" (*Instant Access Properties Ltd (In Liquidation) v Rosser*, [2018] B.C.C. 751, at [404]). This is a difficult test to satisfy, as the unsuccessful claimants in *Rosser* discovered (at [415]). However, given the suspension of wrongful trading liability under s 214, creditors of insolvent companies that suffered losses during the period of suspension may have a greater incentive than usual to allege fraud against the directors.

Will the government introduce additional protections?

CIGA 2020 also empowers the Secretary of State to give directors further protection, but the limits imposed on the power mean that the liability risks outlined above are likely to stay. Section 20 CIGA 2020 gives the Secretary of State a power to amend corporate insolvency or governance legislation for various purposes including to "*change or disapply any duty of*" a company director "*or the liability of such a person to any sanction.*" However, "*corporate insolvency or governance legislation*" is given a relatively narrow definition by s 27 (interpretation). It includes IA 1986 (except so far as relating to the insolvency or bankruptcy of individuals) and CDDA 1986, but does not include any of the provisions codifying directors' duties in CA 2006.

Consequently, if it was felt that the provisions referred to above were still deterring directors from keeping viable businesses going, it is possible to envisage that the Secretary of State would relax these provisions as well, except for the general duties of company directors (including the creditors' interests' duty recognised under s 172(3) CA 2006). However, given the extensive liability risk that directors would still face for breaches of duty including the creditors' interest's duty, relaxing these other provisions would give directors only minimal additional protection. Moreover, further relaxation, especially of the rules on fraudulent trading, would seem inconsistent with the government's reiteration of its commitment to penalising directors who abuse their position (*Hansard*, 3 June 2020, above).

Comment

Despite the new emphasis on preserving viable businesses embodied in CIGA 2020 and s 12 in particular, company directors who believe a Covid-19 related insolvency is on the cards should think very carefully – and would be wise to seek legal and expert advice – before embarking on any attempt to trade their way out. If insolvency is likely, directors' duties under general company law still require them to consider and act in creditors' interests: they must ensure that they are able to do this if they carry on. In the economic turmoil ahead, unpaid creditors desperate to get at least some money back may feel they have little option but to pursue the directors of insolvent companies. Despite the new laws, personal liability remains a non-trivial risk.

Lance Ashworth QC and Matthew Morrison acted for the successful first defendant in *Instant Access Properties Ltd (In Liquidation) v Rosser*, [2018] B.C.C. 751.

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