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Keeping directors in suspense: Wrongful trading under the UK Corporate Governance and Insolvency Act 2020

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The suspension of wrongful trading under the Corporate Governance and Insolvency Act 2020 was introduced to allow directors to trade during the pandemic without the unwanted distraction of potential liability. This article considers whether that objective is likely to be achieved in circumstances where there has been no modification to the common law rules governing duties owed to creditors, and in light of the Court's power to award compensation in disqualification proceedings.

Introduction

The Corporate Governance and Insolvency Act 2020 ("CIGA") received Royal Assent in the UK on June 25, 2020. Almost all of its provisions came into force on June 26, 2020.

Despite making important changes to the UK insolvency landscape, including new moratorium[1] and restructuring[2] regimes, and restrictions on contractual termination provisions triggered by insolvency[3], it passed through both houses of Parliament rapidly in just over a month, with only modest amendments.

This was because of the two measures contained within CIGA relating to COVID-19. The first concerned restrictions on the making of winding up orders. The second, and the subject of this article, was the so-called "suspension of wrongful trading".

The authors first consider whether the temporary measure can genuinely be called a suspension at all, before looking at the additional liabilities to which directors may nevertheless be exposed as a result of their duties to creditors in times of financial difficulty, and the relatively new compensation provisions contained within the Company Directors Disqualification Act 1986 (the "CDDA")[4].

The authors suggest that this suite of potential liabilities means that those advising directors involved in companies which have failed during the pandemic will be able to offer little succour from the suspension.

The position is further complicated because the original suspension provided for by CIGA, s.12 was only in operation from March 1, 2020 until September 30, 2020[5]. It was then reintroduced (but not retrospectively extended) on November 26, 2020[6], at the same time as further lockdown measures started to be imposed. As originally reintroduced, the extension was to April 30, 2021. This was then further extended to June 30, 2021[7]. There is therefore a period between October 1, 2020 to November 25, 2020 during which its protective effect may not be relied upon.

Wrongful trading

IA1986, ss.214 (insolvent liquidation) and 246ZB (administration) provide that a Court may, on the application of a liquidator or administrator, declare that the director is to be liable to make such contribution to the company's assets as it thinks proper where, at a point in time before the company goes into insolvent liquidation or administration, the director *"knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation / entering insolvent administration"*. A director will avoid liability if, after that point in time, he or she took every step with a view to minimising the potential loss to the creditors as ought to have been taken.

The Courts have treated s.214 as a compensatory provision, with the maximum contribution set by reference to the increase in the company's net deficiency between the date when the directors should have concluded there was no reasonable prospect of the company avoiding insolvent liquidation/administration, and the commencement of the liquidation/ administration[8]. The Court then has a wide discretion to order a lower amount, the limits of which it has been held ought not to be spelt out[9].

Where a Court makes a declaration that a director is liable to make a contribution to the company's assets as a result of wrongful trading, it may also make an order for disqualification of up to 15 years, whether or not such an order is applied for (CDDA, s.10)[10].

The "suspension"

Pursuant to CIGA, s.12, in determining the contribution that is to be made to the company's assets, *"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 relevant period, as a result of the extensions described above, is March 1, 2020 to September 30, 2020, and November 26, 2020 to June 30, 2021.

Although the statutory heading preceding s.12 describes this as: *"suspension of liability for wrongful trading"*, it will immediately be seen that the power of the Court to make a finding that there has been wrongful trading is not in fact suspended.

This may have significance if, for example, the Court were to hold that a director ought reasonably to have concluded that a company had no reasonable prospect of avoiding insolvent liquidation/administration at some point during the first period of suspension (March 1, 2020 to September 30, 2021) which continued into the period October 1, 2020 to November 26, 2021, with the company then entering insolvent liquidation/ administration during this period or thereafter. On the face of the statute such a director would be liable for any worsening that occurred in the period when the suspension was not in force. That said, in the authors view it is likely that a Court would take into account the fact that such worsening occurred between the two periods of suspension in exercising its remedial discretion.

The wording of the statute also raises the question whether the assumption may be displaced. CIGA, s.12 uses the language of assumption rather than presumption, and there is no express statement that such assumption is incapable of rebuttal. This may well be tested before the Courts in a suitable case. In the authors' view it is likely that it will be found to be irrebuttable having regard to the parliamentary intention behind s.12 expressed in paragraph 28 of the explanatory memorandum:

"This measure would mean that, when the court is considering whether to declare a director liable to contribute to a company's assets under wrongful trading provisions and is considering the amount to be contributed, it will not take into account losses incurred during the period in which businesses were suffering from the impact of the pandemic. The deterrent to continuing to trade during that period will therefore be removed".

Accordingly, and notwithstanding the potential issues described above, directors will be prevented from having to make a contribution under the wrongful trading provisions even if they ought to have realised there was no prospect of avoiding insolvent liquidation/administration during the relevant periods, and did not take every step that ought to have been taken to minimise loss to creditors.

However, in the authors view this is likely to be of little great significance. Successful wrongful trading cases are rare because of the latitude that is extended to directors faced with the *"real and unenviable dilemma"* of either taking *"the cowards' way out"* and closing down the company, or seeking to trade on and turn the corner[11].

Duties to creditors

In the authors' view a clearer and more present danger arises as a result of obligations directors will come under to creditors when insolvency is looming.

While it has long been clear that where a company is actually insolvent a director's duty to act in the best interests of the company[12] will be treated as a duty to take into account the interests of its creditors (whose interests are at this stage paramount[13]), there has been a considerable degree of uncertainty in the authorities as to when exactly this duty arises.

After a variety of formulations (such as where the company is of doubtful solvency, or there is a real risk of insolvency) the Court of Appeal held in *BTI 2014 LLC v Sequana SA*[14] that the duty arises *"when the directors know or should know that the company is or is likely to become insolvent"*, with *"likely"* meaning *"probable"*.

The Court of Appeal was not required to determine, and left open, the question whether, in circumstances where the company is not presently insolvent but is likely to become so, the interests of the creditors become paramount, or whether there is some sort of sliding scale by which their interests increasingly obtrude. While that uncertainty is regrettable, it is nevertheless clear that a director may face liability at common law notwithstanding the suspension of wrongful trading.

Further, while the wrongful trading regime is focused on the prospects of avoiding insolvent liquidation/administration (as opposed to the company simply being insolvent on a cash flow or balance sheet test), the common law looks at insolvency *simpliciter*. In the authors view the common law test is certainly no less forgiving, and is actually likely to be more strenuous, than that for wrongful trading.

It is also likely that the measure of compensation to be paid for breach of the common law duty will ordinarily be set by reference to the increase in the net deficiency occasioned by the director failing to act in the interests of the creditors, and therefore in many cases will lead to a comparable or, indeed, greater measure of liability than in wrongful trading. Moreover, the broader discretion provided for by IA1986, s.212 (summary remedy for misfeasance) allows for restorative awards of a kind not accommodated by s.214.

True, it is, that a director may be granted relief if acting honestly and reasonably under CA2006, s.1157, and that the duty under s.172 only requires a director to act in what he or she subjectively believes in good faith to be the best interests of the company (here equated with those of the creditors to a greater or lesser degree).

However, where a director has failed to have any regard to the interests of the company an objective test is commonly treated as applying[15], with the Court looking at whether an intelligent and honest man or woman in the position of a director of the company concerned could, in the circumstances, have reasonably believed that the steps taken were for the benefit of the company.

It is unfortunately all too commonly the case that the directors of companies in financial difficulties do not appreciate that their duty to act in the best interests of the company involves taking account of the interests of creditors when the company is likely to become insolvent. Such inadvertence will result in the objective test being applied, and the director in question in all probability failing to meet it.

Compensation in the disqualification context

Finally directors should be made aware of the risk of facing financial liabilities as a result of the provisions introduced into CDDA, s15A by the Small Business Enterprise and Employment Act 2015, s.110 permitting the court to order compensation to be paid at the same time as making a disqualification order.

CDDA, s.6 provides that the Court must disqualify a director for "unfitness". There is longstanding authority that this covers a broad range of conduct and does not require finding that a director is in breach of a specific duty[16]. Further, CDDA Schedule 1 expressly provides that one of the matters to be taken into account is the director's responsibility for the causes of insolvency. Accordingly, there is an obvious risk that a director failing to take steps to protect creditors when a company is in financial difficulties may be disqualified.

The remedial discretion is broad, and includes requiring a director to pay an amount to individual creditors or classes of creditors who have suffered loss, or to make a contribution to the assets of the company. Therefore, recoveries can be made in cases where there is no overall loss to the company, and where particular creditors (such as HMRC) are prejudiced by virtue of a director robbing Peter to pay Paul[17].

Conclusion

Despite the Government's stated intention to allow directors to trade through the pandemic without being inhibited by the spectre of liability, the authors consider that this objective is very unlikely to be achieved having regard to the broader, and more stringent, bases of liability outlined above.

It remains to be seen whether there will follow a spate of breach of fiduciary cases brought against directors who have been seduced by the inaptly named suspension of wrongful trading, and how the Courts appraise unfitness in respect of actions taken during these unprecedented times.

Notes:

1 Under Part A1 of the Insolvency Act 1986 ("IA1986"). Introduced by CIGA, ss.1-6 and Schs 1-8.

2 Under Part 26A of the Companies Act 2006 ("CA2006"). Introduced by CIGA, s.7 and Sch.9, Part 2 of which also makes consequential amendments to a number of further acts.

3 IA1986, s.233B. Introduced by CIGA, ss.14-19.

4 The suspension also has no impact on fraudulent trading under IA1986, ss.213/246ZA. However the number of successful fraudulent trading claims are vanishingly small. While this is a potential liability that must be considered, it is unlikely to be established where a director has acted honestly, even if he or she is at fault in failing to take appropriate steps at a time of financial difficulty.

5 CIGA, s.12(2).

6 Corporate Insolvency and Governance Act 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and Extension of the Relevant Period) Regulations 2020 (SI 2020/1349).

7 Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) Regulations 2021 (SI 2021/375). The Corporate Insolvency and Governance Act 2020 (Coronavirus) (Change of Expiry Date) Regulations 2021 (SI 2021/441), in force from 1 April 2021, confer upon the government a 'Henry VIII power' to amend CIGA so as to apply its provisions (including the wrongful trading suspension) for further periods of up to six months for Covid-19 related reasons.

8 *Re Produce Marketing Consortium Ltd (No.2)* [1989] BCLC 520; *Re Continental Assurance Co of London plc (in liquidation) (No.4)* [2007] 2 BCLC 287; *Re Ralls Builders Ltd* [2016] EWHC 243 (Ch) and [2016] EWHC 1812 (Ch).

9 *Re Produce Marketing*, ibid.

10 The Court may instead refer the matter to the Secretary of State to consider whether or not to commence disqualification proceedings *(Re Idessa (UK) Ltd* [2011] EWHC 804). A finding of wrongful trading, but with no liability to make a contribution to the company's assets, will not suffice (*Re Ralls Builders Ltd* [2016] EWHC 1812 (Ch)).

11 Colourfully described by Park J in *Re Continental Assurance* ibid. at 409. In paragraph 260 of the Government's April 2014 response to the "Transparency and Trust" discussion paper published by the Department of Business, Innovation and Skills in July 2013, it was recorded that since 1986 there had only been 30 reported wrongful trading cases.

12 Originally as a common law fiduciary duty and now under CA2006, s.172, which does not expressly provide for a duty to creditors but preserves (by s.172(3)) any existing rule of law requiring directors to consider or act in the interests of creditors of the company.

13 *Colin Gwyer & Associates v London Wharf (Limehouse) Limited* [2003] 2 BCLC 153

14 [2019] 1 BCLC 347. An appeal to the Supreme

Court was heard on 4-5 May 2021. Judgment is awaited.

15 *Charterbridge Corpn Ltd v Lloyds Bank Ltd* [1970] Ch 62; *Re HLC Environmental Projects Limited, Hellard v Carvalho* [2014] BCC 337. Cf *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 and *Re Blackwood Hodge plc* [1997] 2 BCLC 650.

16 *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164

17 The compensation regime was analysed in detail by ICC Judge Prentis in *Re Noble Vintners* [2020] BCC 198.

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