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Wrongful Trading Suspension:
Does it create a false sense of security?

On 28 March 2020 the Government announced a range of measures aimed at protecting companies affected by COVID-19 and their directors, as they try to steer businesses through choppy waters in the next few months. The measures include the temporary suspension of wrongful trading provisions for a 3 month period from 1 March 2020. The legislation is yet to be published and the detail will be important, but the general aim of the legislation has been publicly stated already by the Business Secretary.

The relaxation of the wrongful trading rules is intended to reassure directors that the difficult decisions they have to make about the future viability of their business will not have to be unduly influenced by the exceptional circumstances which are entirely beyond their control.

But directors should not be lulled into a false sense of security by the suspension of the wrongful trading provisions.

The upshot of a director being held liable for wrongful trading is that the Court may declare that the director is to be liable to make such contribution to the company's assets as the Court thinks proper. The wrongful trading test is triggered where, at some time before the commencement of a liquidation or administration, a director knew or ought to have known that there was *no reasonable prospect that the company would avoid going into insolvent liquidation or entering insolvent administration*, and a director has failed to take every step with a view to minimising the potential loss to creditors (s.214 and 246ZB Insolvency Act 1986 ("IA1986")).

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However a director's common law duty to consider the interests of creditors (preserved by s.172(3) Companies Act 2006 ("CA 2006")) is triggered when a director knows or should know that the company *is or is likely to become insolvent* (BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112). This duty has not been suspended and, if breached, may separately result in a director incurring personal liability.

Moreover, the s.172(3) duty is more easily engaged than the wrongful trading provisions:

- The threshold test of "*is likely to become insolvent*" for the purpose of s.172(3) is less onerous than the "*no reasonable prospect that the company would avoid going into insolvent liquidation / administration*" test for wrongful trading.

- Further, for the purpose of wrongful trading, a company "*goes into insolvent liquidation*" if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities, and the expenses of the winding up (s.214(6); s246ZB(6)). So it is balance sheet, not cash-flow insolvency, which is relevant.

- In contrast, the duty under s.172(3) will be engaged where a director knows or ought to know that the company is, or is likely to become, insolvent on *either* the cash-flow or balance sheet basis (s.123(1)(e) and s.123(2) Burnden Holdings UK Ltd v Fielding [2019] EWHC 1566 (Ch) [344]).

Regrettably, there is yet a further layer of uncertainty because BTI v Sequana is presently on appeal to the Supreme Court. Grounds for appeal include the question of whether the trigger for the creditors' interest duty under s.172(3) is merely "*a real risk of*", as opposed to a probability of or close proximity to, insolvency. In other words, it is possible that the Supreme Court may find that the trigger for a director's duty under s.172(3) is lower than "*is likely to become insolvent*". The appeal was due to be heard on 25 March 2020 but ironically was adjourned due to the present situation. Accordingly, there is unlikely to be clarity on this point in the immediate future.

It should be noted that breach of the wrongful trading provisions is not a criminal offence and only attracts civil liability. This is in contrast to fraudulent trading which is a criminal offence under s.993 CA2006 as well as attracting civil liability under s.213 and s.246ZA IA 1986 (which provisions have not been suspended).

BTI v Sequana: Court of Appeal

Key features of the creditors' interest duty under s.172(3) which were not in dispute in BTI v Sequana are that:

1. The effect of s. 172(3) is to retain the common law principles as to when the duty arises;

2. The duty is owed to the company, not to creditors;

3. There is a single threshold for when the duty arises for all decisions taken by directors;

4. The content of the duty does not vary according to the degree of risk of insolvency; and

5. A failure to have regard to the interests of creditors is not of itself a breach of duty, if the directors could have reasonably concluded that the proposal should be approved even if creditors' interests were taken into account.

It was also common ground that the duty could be engaged when the company was not actually insolvent: i.e. something short of actual insolvency is sufficient. The issue is how close to insolvency does the company have to be?

After a thorough analysis of the authorities, during which it was observed that the recognition of the creditors' interests duty was remarkably recent (it first appeared in the Australian case of Walker v Wimborne [1976] HCA 7 and in English authorities in Re Horsley & Weight [1982] 3 All ER 1045), David Richards LJ concluded that there was no decision in any English authority which is clearly based on the proposition that the creditors' interests duty is triggered by anything short of actual insolvency, as in all the English cases, the company was actually insolvent (see for example in West Mercia Safetywear Ltd (in liq) v Dodd [1988] BCLC 250, CA). Nonetheless the number of times that judges had assumed that something short of actual insolvency would suffice, carried weight.

The Possible Candidates

David Richards LJ considered there were 4 candidates for the trigger:

1. Actual insolvency: there is no doubt on the authorities that the duty is engaged at this point.

2. "On the verge of insolvency" or "nearing or approaching insolvency".

3. Where the company "is or is likely to become insolvent".

4. Where there is "a real, as opposed to a remote, risk of insolvency".

The Court of Appeal held that the third test "*is or is likely to become insolvent*" was the applicable test. The fourth test, contended for by the claimant, was rejected as inappropriate in light of the policy considerations (namely that it would dampen entrepreneurial activity and make directors too risk averse), however the claimant is pursuing this on its appeal to the Supreme Court.

The second option was rejected as it suggested a temporal limit (i.e. that the test required the insolvency to be imminent or that actual insolvency would be established within a short time). Whilst acknowledging that that may cover many situations in which the duty is triggered David Richards LJ said [219]:

> "*the company may be able to pay its debts as they fall due for some time, perhaps a considerable time, to come, insolvency is nonetheless likely to occur and decisions taken now may prejudice creditors when the likely insolvency occurs*"

So it is important for directors to keep firmly in mind that insolvency does not have to be "likely" in the near future for the duty to be engaged.

Content of the Duty

As to the content of the duty, the Court of Appeal expressed no concluded view on whether once the duty is engaged creditors' interests are"paramount", or whether it is sufficient simply to take them into account, save that David Richards LJ said [222]:

> "*where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors' interests could be anything but paramount*".

The trigger for s.172(3) is broader and less precise than wrongful trading. It is also to be assessed by reference to whether a director knew or ought to have known that the company "is or is likely" to become insolvent.

Breach of the duty under s.172(3) requires it to be shown that a director did not act in a way that they considered, in good faith, would be most likely to promote the success of the company, including considering the interests of creditors. Where there is evidence that a director has considered the interests of creditors, the duty is subjective in the sense that the question is not whether, viewed objectively by the court, the particular act or omission was in fact in the interests of the company, having regard to creditors' interests, or whether the court might have acted differently. Rather it is whether the director honestly believed that his act or omission was in the interests of the company, having regard to the interests of creditors (<u>Re Regentcrest Plc v Cohen</u> [2001] BCC 494 [120]). An absence of good faith on the part of the director must be shown. This is in contrast with the wrongful trading provisions which do not depend on a lack of good faith, but are by reference to a reasonably diligent person having both (i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director and (ii) the general knowledge, skill and experience that that director has. So whereas the trigger for the engagement of the creditors' interest duty under s.172(3) is a lower threshold than the wrongful trading provisions, a higher degree of culpability is required for breach to be established. This may be the policy justification for not interfering with s.172(3) during the COVID-19 pandemic.

However, where s.172(3) is triggered but there is no evidence that a director considered the interests of creditors *at all*, an objective test will apply: namely whether an intelligent and honest man in the position of a director of the company concerned could, in all the circumstances, have reasonably believed that the transaction was for the benefit of the company[1]. Equally, where a very material interest, such as that of a large creditor is unreasonably overlooked and not taken into account, it has been held that the objective test should be applied[2]. Therefore, where s.172(3) is triggered and a director overlooks creditors in a manner which is not objectively justified, there remains a potential for personal liability even absent proof of bad faith.

De Facto / Shadow Directors

The duty under s.172 is not confined to registered directors. There is no real doubt that it applies to *de facto* directors (s.250 CA 2006 defines director as "*any person occupying the position of director, by whatever name called*").

Whilst the position in relation to shadow directors has been subject to some judicial debate[3], since the coming into force of the Small Business, Enterprise and Employment Act 2015 ("SBEEA") s.170(5) CA 2006 has been amended to provide that (subject to any regulations which may be made) the general duties apply to a shadow director where and to the extent that they are capable of so applying. So the default position is that the general duties will apply to a shadow director, unless they are not capable of applying. However the Explanatory Note to the SBEEA[4] stated in relation to the amendment that "*This change in default position is neither intended to preclude the courts from looking at the application of the duties on a case by case basis, nor from drawing on existing case law in any given case*". So the position in relation to shadow directors will be more fact sensitive and nuanced.

Corporate Groups

Directors of group companies should keep in mind that each company within the group is a separate legal entity, with its own assets and liabilities. The trigger and application of the duty should be assessed in relation to each company individually (although the fact that directors of a company within a group have considered the interests of the group as a whole does not automatically mean that they are in breach of duty, provided an intelligent and honest man in the position of the directors could have reasonably believed the transaction to be in the interest of the company itself (Charterbridge v Lloyds [1970] Ch 62, 74)). Clearly where a

[1] Charterbridge v Lloyds [1970] Ch 62, 74; HLC Environmental Projects Ltd [2014] BCC 337 [92]; and Madoff Securities International Ltd v Raven [2013] EWHC 3147 (Comm) [192]
[2] HCL Environmental [92] ibid.
[3] Yukong Line v Rendsburg Investments [1998] 2 BCLC 485, 502h; c.f. Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638 [1284] to [1290]. Vivendi SA v Richards [2013] BCC 771 [139] – [140] and Instant Access Properties Ltd (in liq) v Rosser [2018] EWHC 756 (Ch)
[4] In relation to SBEEA s.89.

group includes foreign companies, directors will need to consider the law of the relevant jurisdiction and take appropriate foreign law advice.

Protective Measures

Given the economic impact of COVID-19 directors would be well advised to monitor their company's financial position (maintaining accurate management accounts and up to date forecasts), hold regular (remote) meetings and keep accurate records of decision making (full minutes) together with information relied on in support. Appropriate financial and legal advice should be sought (a factor which the court would almost certainly take into account in the event that an allegation of breach of duty were ever made). Depending on the financial position, this might include taking advice from an insolvency practitioner as to whether any form of insolvency procedure is appropriate such as a CVA, administration or liquidation. Consultation with creditors may well be appropriate (particularly major creditors).

Other Relevant Provisions

Whilst directors may welcome the temporary suspension of the wrongful trading provisions during the COVID-19 pandemic, there are other provisions of the IA1986 which have not yet been the subject of any Government announcement and which should remain in the minds of directors.

At present, the law in the following related areas remains unchanged:

- The remedy for misfeasance by directors under s.212 IA 1986. This section provides a summary remedy in the liquidation of a company for the restoration of property to it and the assessment of compensation or damages for breach of duty against its former officers (including breach by directors of their general duties under s.170 to 177 CA 2006);
- Fraudulent trading under ss.213 and 246ZA IA 1986. These provisions can impose civil liability on directors where it appears in the course of a liquidation or administration that any business of the company has been carried on with intent to defraud creditors of the company, or creditors of any other person, or for any fraudulent purpose. Fraudulent trading is also a criminal offence under s.993 CA2006. Notably s.993 applies whether or not the company has been, or is in the course of being, wound up;
- Office-holder claims in relation to transactions made by a company prior to its entry into administration or liquidation (i.e. transactions at an undervalue (s.238 IA1986) and preferences (s.239 IA1986) whilst a company is insolvent). These sections, together with s.241 IA1986, give the Court the power to make such order as it thinks fit for restoring the position to what it would have been if the company had not entered into the relevant transaction. Separately, the decision to enter into such

a transaction may, depending on the circumstances, be challengeable as a breach of a director's duty for which the court may order a director to be personally liable to compensate the company;

- Transactions defrauding creditors under s.423 IA 1986. In the corporate context, where a transaction takes place at an undervalue or the company makes a gift, this section allows an insolvency office holder (administrator, liquidator, supervisor of a CVA or Official Receiver) or the victim of a transaction (including a creditor), to ask the Court for relief including to make an order unwinding the transaction if the defendant entered into the transaction for the purpose of putting assets beyond the reach of a person or otherwise prejudicing the interests of a person who is making, or may at some time make, a claim against the defendant. As with s.238 and 239, the decision to enter into such a transaction may, depending on the circumstances, be challengeable as a breach of a director's duty for which the court may order a director to be personally liable to compensate the company.

Furthermore, when, and the circumstances in which, directors can be disqualified under the Companies Directors Disqualification Act 1986 remains unchanged.

Transaction Avoidance: s.127 IA 1986

Section 127 IA1986 provides that any disposition of the company's property, any transfer of shares, or alteration in the status of the company's members made after the commencement of the winding-up is, unless the course otherwise orders, void. It is *presentation* of the petition which triggers the effect of s.127 if a winding-up order is ultimately made on the petition. Therefore directors must continue to have the provisions of s.127 firmly in mind if a winding-up petition is or has been presented, even if the winding-up hearing has been adjourned for a lengthy period because of the COVID-19 pandemic (For example certain petitions listed in the Rolls Building in mid-March 2020 were adjourned in blocks of between 12 and 19 weeks).

A validation order under s.127 may be needed. The provisions of the Insolvency Practice Direction of July 2018 set out in detail the mechanics of such an application and what the evidence is expected to cover.

Applications for validation orders are often time critical and may in appropriate circumstances be suitable for issue on an urgent basis. In determining whether an application is urgent the parties should consider, amongst other things, what prejudice may result from delay and whether or how that prejudice may practicably be avoided otherwise than by court proceedings.

If an application is considered to be genuinely urgent then the steps set out at paragraph 5 of the Temporary Insolvency Practice Direction (which came into force on 6 April 2020 as a response to the COVID-19 crisis and will remain in effect until 1 October 2020, unless revoked or amended in the meantime) should be followed to have the hearing listed and determined.

- The Applicant should email the ICC Judges' clerk at Rolls.ICL.Hearings1@justice.gov.uk or the relevant High Court Judge's clerk requesting that the hearing be listed on an urgent basis. The email must set out the nature of the application, the reason(s) why it is urgent, time estimates for pre-reading and the hearing, the number of parties that will need to attend, and must confirm that the hearing can proceed by video link or telephone.
- The Judge's clerk will ordinarily then allocate the hearing to a Judge and send an appropriate meeting invitation or dial in details to the parties.[5] They will also address any practical issues arising from the application, including whether the application should be issued and paid for via CE-Filing or whether an undertaking to issue and pay the hearing fee will be required.
- In advance of the hearing the Applicant must provide PDF copies of essential documents either to the Judge's clerk or (if provided) via link to an online data room.
- Following the hearing directions may be given for a draft minute of order to be lodged electronically, which will be sealed and returned in the usual way.

The Temporary Insolvency Practice Direction also makes important provision in relation to the filing of notices in respect of administration and the hearing of winding up and bankruptcy petitions.

It should also be noted that as from 6 April 2020:
- Any witness statement filed in support of an application must state the process by which it has been prepared (for example, following discussion over the telephone or by video conference): (CPR PD32.18.1 (5)); and
- The form of the statement of truth has also been amended (CPR PD 22.2).

Personal Insolvency Equivalents

The focus of this article has been on corporate insolvency. However, it is important to bear in mind that many of the above provisions have an approximate equivalent in the context of bankruptcy/personal insolvency, often with many similarities and some differences. In particular, to the extent that individuals behind companies have given personal guarantees for business debts, COVID-19 may have significant ramifications for those individuals and, accordingly, the following provisions in particular should be borne in mind:
- ss.339, 340 and 342 (office-holder claims in relation to prior transactions);
- chapter VI of Part IX of the IA 1986, ss.350-362 (bankruptcy offences);
- s.423 IA 1986 (as above);

[5] If the parties disagree with the court's proposed method of hearing they may make written submissions as to what other proposal would be more appropriate: para 8.2, Temporary Insolvency Practice Direction.

- s.284 (the avoidance of transactions made between presentation of bankruptcy petition and the making of a bankruptcy order) and the provisions of the Insolvency Practice Direction July 2018 on validation orders.

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