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ARTICLE

The Position of UK Directors during the COVID-19 Pandemic

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Synopsis

In the current pandemic and consequent lockdown UK company directors face many challenges and risks. The government has recently announced that wrongful trading liability under Section 214 of the Insolvency Act 1986 will be suspended for an initial period of 3 months in order to alleviate directors' concerns about personal liability when deciding whether or not to continue trading. However, other duties and routes to personal liability remain in place and directors are by no means 'off the hook'. This article examines the impact of the suspension of wrongful trading liability and gives some advice on best practice for directors seeking to minimise the risk of liability should the company later enter an insolvency proceeding.

Introduction

The COVID-19 pandemic has changed everyday life immeasurably in a short space of time, and presented businesses with a range of serious challenges, both in the short-term and for the future. Many businesses are facing their toughest trading environment in living memory and some have been forced by lockdown measures to stop trading altogether. With no certainty as to how and when the current lockdown will end, many company directors face the difficult task of deciding whether to enter an insolvency procedure, or to try and trade out of a position of cash-flow or even balance-sheet insolvency.

As company directors try to meet the immediate challenges to their business on a daily basis, they may well be mindful of the potential risk that they will be held personally liable for their current actions. Although, as set out below, the UK Government is trying to reduce directors' anxieties in this regard by suspending wrongful trading liability under Section 214 of the Insolvency Act 1986, English law imposes a number of other specific duties on directors that must be complied with even in these extraordinary times.

Directors' duties and liabilities – the factual position

Directors' duties under English law derive from a variety of sources, principally common law, the Companies Act 2006 and other statutes, for example health and safety, employment and environmental legislation. The 2006 Act codified long-standing (and perhaps common-sense) duties, as a reminder:

– to act within their powers according to the company's constitution and only exercise powers for the purposes for which they are conferred (section 171);
– to act in a way that they consider in good faith will promote the success of the company for the benefit of its members as a whole (section 172);
– to exercise independent judgment when fulfilling their duties (section 173);
– to exercise reasonable care, skill and diligence (section 174);
– to avoid actual or potential conflicts between the director's interest and the interests of the company, and not to exploit or profit from their position within the company (section 175);
– not to accept benefits from third parties conferred by reason of being a director or doing (or not doing) anything as a director (section 176);
– to declare any interest in proposed or existing transactions or arrangements with the company to the board (sections 177–182).

These general duties, owed to the company, are cumulative (section 179) and, in the event of wrongdoing, it is not uncommon for a director to be held in breach of more than one of them.

The general duties are focussed on the director's duties to promote the company's success in the interests of its shareholders. However, when the company is insolvent or likely to become so, the directors are then required to act primarily in the best interests of the company's creditors as a whole, maximising (or at least preserving) the value of the company's assets.

As is well-known, a company can be insolvent in cash-flow terms if unable to pay its debts as they fall due, and/or in balance sheet terms, where its liabilities are more than its assets at a given time (see section 123 of the Insolvency Act 1986). At present, with large sectors of the economy shut down and many businesses unable to generate revenue but still liable to meet fixed costs, it is anticipated that a large proportion of otherwise viable companies could find themselves technically insolvent.

In an insolvency context other potential claims against directors also arise. Apart from wrongful trading (which will be dealt with below) the 1986 Act provides a range of remedies against directors and ex-directors of companies in liquidation. For instance, pursuant to section 212 any director who has misapplied or retained, or become accountable for, any company money or other property or who has been guilty of any misfeasance or breach of duty can be ordered to repay, restore or account for that property (plus interest) or to pay such compensation to the company as the court thinks just. Breaches of duty in this context include negligence and breaches of the general 2006 Act duties set out above. Section 213 of the 1986 Act provides that directors who are guilty of carrying on company business with intent to defraud creditors can be ordered to make contributions to the company's assets.

Furthermore, certain transactions can be set aside or clawed-back in the event of liquidation or administration. The most common examples are transactions at an undervalue (section 238) and transactions amounting to unlawful preferences of particular creditors, sureties or guarantors (section 239).

It should also be noted that where a company has become insolvent a director may be disqualified from acting as a director pursuant to the Company Directors' Disqualification Act 1986 if his conduct makes him unfit to be concerned in the management of a company. There are also numerous criminal offences under the Insolvency Act 1986 relating to fraudulent conduct e.g. in relation to falsification of company books or false representations to creditors (see Sections 206–211).

Wrongful trading liability

By way of summary, wrongful trading pursuant to section 214 of the Insolvency Act 1986 is the continuation of trading by a company at a time when the company is unable to pay its debts as they fall due.

The Section applies if, at some time before the commencement of winding up, the director 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or entering insolvent administration' (Section 214(2)(b)), but nonetheless allowed the company to keep on trading. The director is held to the standard of a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions; and (b) the director's actual general knowledge, skill and experience (Section 214(4)). The standard therefore contains an objective element.

However, pursuant to Section 214(3) the Court should not require a director to make a contribution if, after the time when the director first knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation 'that person took every step with a view to minimising the potential loss to the company's creditors as [assuming him to have known that there was no reasonable prospect that the company would avoid going into liquidation] he ought to have taken'.

This defence is construed strictly and requires a director to demonstrate not only that continued trading was intended to reduce the company's net deficit, but also that it was designed so as to minimise the risks of loss to individual creditors, including new creditors incurred during the wrongful trading period (see *In re Ralls Builders Ltd* [2016] Bus LR 555 (Snowden, J.) at para. 245).

Directors are therefore potentially subject to unlimited personal liability for their conduct prior to commencement of the winding-up. The case-law suggests that any contribution is based on the loss suffered by the company caused by the wrongful continuation of trading. The starting point for assessment is the increase in the net deficiency of the company's assets as regards unsecured creditors during the wrongful trading period, but only to the extent that that increase was caused by the wrongful trading (see *Ralls Builders* (cited above) at paras 241–242). Losses that would have been incurred in any event due to the company's insolvency or entering a formal insolvency procedure are not included. It is possible, as in *Ralls Builders* itself, that a period of wrongful trading may actually improve the company's net deficiency by allowing for enhanced collection of contract debts compared to an earlier cession of trading.

However, liability for wrongful trading is relatively rare and the mere fact that a company is insolvent (whether on a balance-sheet or cash-flow basis) and carries on trading is insufficient. It is common for companies to experience cashflow difficulties or balance sheet deficits from time to time. The requirement is not that the company was insolvent, but that there was no reasonable prospect of avoiding liquidation as a result, and the courts are mindful that it is unhelpful to rely too much on hindsight (see *In re Hawkes Hill Publishing Co* [2007] BCC 937 per Lewison J. at paras 28 and 47). The typical case is one where a director closes his or her eyes to obvious reality and has no rational basis for believing that an event which would save the company will come about.

Suspension of the application of Section 214 – the government announcement

Given the obvious risks of insolvency during the current pandemic, directors who carry on trading, incurring credit and/or paying salaries and suppliers, could be exposed to liability for wrongful trading under section 214 if their companies enter liquidation. At present it is very difficult for directors to make the sort of assessment required by section 214, in that the chance of avoiding insolvent liquidation will depend on when and how the current lockdown is lifted and what financial support, if any, companies receive from the State.

On 28 March 2020 the Business Secretary Alok Sharma announced that wrongful trading liability will be suspended retrospectively from 1 March 2020 for an initial period of three months. The relevant press release stated as follows:

> 'The government will also temporarily suspend the wrongful trading provisions 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. Existing laws for fraudulent trading and the threat of director disqualification will continue to act as an effective deterrent against director misconduct'.[1]

The suspension is intended to give directors some breathing space, and to prevent a rush of insolvent liquidations as directors opt for winding-up rather than face potential personal liability. As of 11 May 2020 there is only a short Commons Briefing Paper (number 8877) regarding the suspension of wrongful trading and the government have not presented any draft legislation on this subject. The precise way in which the suspension will operate and its scope are therefore unknown. Given the uncertainty it would be a brave company director who relied solely on the announcement when making key business decisions at the moment.

Implications of government announcement

While the government's announcement gives something of a boost to directors trying to 'keep calm and carry on', it also raises a number of practical issues. Most obviously, while liability for wrongful trading is suspended, directors may still be liable for breaching their other duties, including the duty to consider the interests of the company's creditors as a whole in times of doubtful solvency.

Furthermore, other avenues to personal liability remain, such as fraudulent trading, misfeasance, breach of the Companies Act 2006 duties, as well as the threat of disqualification. While the practical effect of the suspension may be that certain expenditure or borrowing during the suspension period does not amount to wrongful trading, a director incurring further credit at a time when they know that the company will be unable to pay it back when due may face liability (e.g. under section 213 of the Insolvency Act 1986). Any future administrator or liquidator of the company is likely to review directors' conduct and explore any avenues for recovery against them.

Given the urgency of the situation, it is perhaps regrettable that the government has not yet produced draft legislation or provided any real detail of how the suspension will operate. For instance, it is unclear whether section 10 of the Company Directors' Disqualification Act 1986 (which allows a court to make a disqualification order against a director found guilty of wrongful trading under section 214 Insolvency Act 1986) will also be suspended. If a director would (bar the suspension) have been found liable under section 214 then it is unclear whether this is a ground for disqualification under section 10 of the 1986 Act.

Another obvious problem is that the suspension is merely temporary and, unless extended in due course, only for three months – to the end of May 2020. There may be cases where wrongful trading predated 1 March and continued into the suspension period or, conversely, began within the suspension period and then continued after the suspension was lifted. It is unclear how such cases will be dealt with from a liability standpoint but further difficulties arise regarding quantum. As set out above, a director's contribution under section 214 is usually calculated by reference to the amount that the net deficiency increases as a result of the wrongful trading after the date that the court finds the directors should have put the company into an insolvency proceeding. The added complexity of applying this approach in a case where a director has been wrongfully trading both within and outside the suspension period is obvious.

Advice for directors

The situation faced by any company director is of necessity fact-specific. Any concrete steps or business decisions will depend on the particular business and the factual scenario that the company finds itself in. However, some general advice on best practice can be given:

Notes

1 Press release dated 28 March 2020 <https://www.gov.uk/government/news/regulations-temporarily-suspended-to-fast-track-supplies-of-ppe-to-nhs-staff-and-protect-companies-hit-by-covid-19> accessed on 5 May 2020.

- Seek professional advice on key legal and financial issues and, potentially, from an insolvency practitioner or 'turnaround specialist'.
- Explore the various measures announced by the government to ease cash-flow and assist with the financial impact of the pandemic e.g. loan schemes, employee furlough schemes and business rates holidays.
- Consider and act in the best interests of the company's creditors as a whole, especially when deciding whether or not to continue trading. In a rapidly evolving situation such as the current pandemic, the course of action in the creditors' best interests may change, and therefore this needs to be reviewed very regularly. Taking and recording advice from an insolvency practitioner or lawyer may provide some assistance in the event of subsequent enquiry by a liquidator or administrator.
- Remember that, given the likely difficulty of finding a buyer willing to pay a business' fair value at the present time, it is not inevitable that a company's creditors would be in a better position if the company immediately entered an insolvency procedure. However, no assumptions should be made in this regard and the question must be considered on a regular basis.
- Document all business decisions and the reasoning behind them. This is crucial in order to evidence that directors took creditors' interests into account when making decisions. As well as board minutes, directors should consider producing and/or reviewing revised versions of documents such as management accounts, trading and cash flow projections and a plan of how the company will operate during the pandemic and its aftermath. These documents should also be re-considered and adapted as necessary to keep up with changing circumstances.
- Keep communicating with key creditors and stakeholders such as banks and suppliers.
- Once the suspension of wrongful trading liability ends, reconsider the requirements of section 214 and ensure that directors are not wrongfully trading or at risk of doing so. In particular, a director should assess whether there is a reasonable prospect of avoiding insolvent administration or liquidation and, if not, take every step to minimise losses to creditors.

Things to avoid:

- Incurring new liabilities (whether from government schemes or other sources) when the director knows that there is no prospect of repayment or no credible plan for meeting such liabilities when they fall due.
- Repaying liabilities where directors have given personal guarantees in preference to other liabilities or otherwise preferring certain creditors over others, other than in the normal course of trading. The obligation is to consider the interests of creditors as a whole, not just particular creditors or classes of creditor.
- Transferring assets to connected persons or companies other than in the usual course of business.
- Paying out dividends or bonuses where the company is on the brink of failure.

Conclusion

The above analysis is not meant to strike fear into the heart of company directors, but to encourage a conscientious and responsible approach. The suspension of wrongful trading liability is intended to ensure that directors acting in good faith in difficult circumstances are not unduly penalised. Some comfort may also be taken from section 1157 of the Companies Act 2006, where the Court is empowered, in any proceedings against a director for (inter alia) negligence, breach of duty or breach of trust, to relieve the director either wholly or partly from liability if they have acted honestly and reasonably and ought, in the circumstances, fairly to be excused. The need for further Government guidance and, preferably, draft legislation, is pressing. It should not fall to the courts to have to determine (in an information vacuum) what is fairly to be excused. However, directors can take some comfort from the pragmatism and common-sense of the commercial and chancery judges upon whom the burden of filling the information void may, ultimately, fall.

International Corporate Rescue

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