Directors' Duties & Light Touch Administrations in the Covid-19 Era

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Introduction – emerging themes

1. As of 28 March 2020, the UK government announced a number of reforms to UK insolvency laws including a temporary suspension of existing wrongful trading rules, in respect of directors' actions for three months beginning from 1 March 2020 which is likely to be extended. This suspension is intended to ensure that directors in this uncertain COVID-19 environment are able to take decisions to continue to trade and incur new credit — including under the government funding initiatives currently in place — decisions which may otherwise cause directors concern about the potential for personal liability under the wrongful trading regime set out in sections 214 and 246ZB of the Insolvency Act 1986 **("IA 1986")**.

2. The fact that wrongful trading has become increasingly difficult for office holders to utilise as a recovery tool suggests that this may have been a political rather than a practical step. However, that led to a concern that whilst directors may avoid a claim for wrongful trading, it would not

prevent a possible claim against them for breach of duty, for example for continuing to trade and incur liabilities where the company was insolvent.

3. Another emerging theme in these Covid-19 times is the potential use of light touch administration, which allows company directors to file for administration but retain day-to-day control, rather than ceding power to insolvency practitioners. This is not new and, in certain limited circumstances, the use of agents to run the operational aspects of a trading administration has been approved by the court. On 16 April 2020 the Financial Times pointed out that one of the hurdles was that insolvency practitioners were unwilling to take on the risk where they may be held personally liable for management decisions taken during the administration process and so will have to tightly monitor all transactions, expenses and contractual agreements made during that time. In one unattributable quote it was said:

> "*There's no way a big firm would get it passed their internal risk committee," said a partner at another restructuring practice. He said the liability for partners if something went wrong would be too great, even if the appointing party offered some kind of indemnity."*

4. Therefore, Covid-19 has created an unusual alliance, directors who may not be prepared to continue trading because of a potential breach of duty claim and potential office holders who may not be willing to take an appointment for the same reason.

5. This talk tries to address the question of whether those fears are justified, primarily looking at it from a director's viewpoint, but with a quick look at the position of an office holder.

Directors duties

6. The general duties owed to a company by its directors are now enshrined in statute in the Companies Act 2006 **("CA 2006")**. This followed the recommendation of the Law Commission in their report in 1999 which itself was the latest in a line of reports spanning the previous 100 years, most of which had recommended the introduction of a statutory statement of directors' duties in one form or another.

7. As explained by Lord Goldsmith, the Attorney General at the time, the purpose of codification is *'to make what is expected of directors clearer and to make the law more accessible to them and to others'*.

8. Those general duties are the duties to:

   8.1. Act within powers (s.171 CA 2006);

   8.2. Promote the success of the company (s.172 CA 2006);

   8.3. Exercise independent judgment (s.173 CA 2006);

   8.4. Exercise reasonable skill, care and diligence (s.174 CA 2006);

   8.5. Avoid conflicts of interest (s.175 CA 2006);

   8.6. Not to accept benefits from third parties (s.176 CA 2006);

   8.7. Declare any interest in a proposed transaction or arrangement (S.177 CA 2006).

9. Whilst these statutory duties are based on, and take effect in place of, the pre-existing common law rules and equitable principles as they applied to

directors[1], they were expressly stated to be interpreted and applied in the same way as those rules and principles[2].

10. The intention at the time of introduction was to allow the duties to develop over time, as they had in the past, and to be sufficiently flexible to enable the law, and the courts, to respond to changing business circumstances.

11. Neither was it intended that the Companies Act 2006 would be provide a complete code, there are other duties and as was said at the time the statement was not an exhaustive list; there are a wide range of other duties a director owes to the company, for example under the Insolvency Act 1986.

12. One significant duty which remains uncodified, and which has developed recently, is the duty owed to consider the creditors interest duty when the company is insolvent or potentially insolvent which first emerged in Australia in 1976 and was first mentioned in the English authorities by Lord Templeman in 1982 *Re Horsley & Weight Ltd* [1982] Ch 442. This duty is considered in more detail below.

13. There is also the difference between the duties of a fiduciary nature (which have developed in accordance with equitable principles and continue to do so, an example being the duty to promote the success of the company contained in s.172 CA 2006) and those relating to skill and care which have developed at common law. The nature of the duties has developed as the commercial environment has changed.

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[1] *S.170(3) CA 2006*

[2] *S.170(4) CA 2006*

14. An example of the courts updating its approach is the so-called privilege of limited liability. Both the courts and the legislature have until very recently considered this to be a privilege and expected higher standards from those who sought to benefit from it by imposing personal liability where it was abused, the wrongful trading provisions being an example. Legislation also "punishes" those who it considers abuse that privilege of limited liability for their own gain as is demonstrated by the Company Directors Disqualification Act 1986. In *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 | [2019] 2 All E.R. 784 the description of limited liability as a privilege was described as outdated, David Richards LJ said:

> *"With respect, this is, in my view, a mistaken approach. In English law, the right to form and a register a company under the Companies Act is, in no sense, a privilege. It is a right conferred by statute in unqualified terms, and it is a right that Parliament created over 170 years ago in the public interest and for the purpose of advancing the economic well-being of the country."*

15. In any event the so-called privilege of limited liability is not conferred on directors, the protection is afforded to shareholders who may well not be one and the same. But this is an example of the development of judicial thinking moving with the times.

16. There can be no doubt that the regime under the Companies Act 2006 was designed to develop in line with corresponding changes in other areas of law, but that evolution takes place over time. The question facing directors in the current climate is whether the system can, and will, adapt to take into account the unique challenges they face in the Covid-19 Era. The same question faces potential office holders when asked to act on a light touch administration, can the test applied by the courts adapt, and do so quickly enough, to take into account the environment in which they are operating. Whilst it is never possible to give a definitive answer, each case is fact sensitive, of all areas of law this is one which is able to adapt and does.

Subjective nature of the duties

17. The duty imposed by s.172 CA 2006 (and its common law predecessor) is ordinarily regarded as a subjective one. As put by Jonathan Parker J in *Regentcrest plc (in liq) v Cohen* [2001] 2 BCLC:

> *"The question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather, the question is whether the director honestly believed that his act or omission was in the interests of the company. The issue is as to the director's state of mind. No doubt, where it is clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's interest; but that does not detract from the subjective nature of the test."*

18. The general principle of subjectivity is however subject to three qualifications: *Re HLC Environmental Projects Limited* [2013] EWHC 2876. Firstly, where, in cases of insolvency or dubious solvency, the duty extends to consideration of the interests of creditors, their interests must be considered as 'paramount'. Secondly, the subjective test only applies where there is evidence of actual consideration of the best interests of the company. Where there is no such evidence, the proper test is objective, namely, whether an intelligent and honest man in the position of a director of the company could, in the circumstances, have reasonably believed that the transaction was for the benefit of the company. Thirdly, where there is a very material interest, such as that of a large creditor (in a company which is insolvent or of doubtful solvency) which is without objective justification overlooked and not taken into account, the objective test must equally be applied.

19. Section 172 CA 2006 contains the main duty of a fiduciary nature and has been described as the fundamental duty to which a director is subject and the duty from which the other fiduciary duties of a director flow, therefore looks at the honest belief of a director that he acted in the interests of the company where he positively considers the situation. It should be stressed that he does not have to be right.

20. Section 172(3) CA 2006 recognises the existence of an external duty to have regard to the interests of creditors on insolvency, actual or likely. The authorities on the nature and development of this duty were reviewed most recently by the Court of Appeal *in BTI 2014 LLC v Sequana SA* [2019] 2 All E.R. 784 (at paragraphs [105] to [102]) which held that the applicable trigger for the creditors' interest test is where company is or is likely to become insolvent accurately encapsulates the trigger. In this context, "likely" means probable.

21. Where that duty is triggered, where the director fails to consider the best interests of the company or overlooks a material interest, the test is objective and importantly takes into account all the surrounding circumstances. It does not look at the decision in isolation.

22. So far as the s.174 CA 2006 (which is evidently modelled on the wrongful trading provisions in s.214 IA 1986) duty of skill and care is concerned, it as can be seen from section itself, has objective and subjective elements. A director will initially be judged by the skill and experience of a person carrying out the functions carried out by the director in relation to the company and secondly the general knowledge and skill that the director has.

23. Therefore, in relation to potential breaches of duty by a director it is clear that that the jurisdiction is designed to be flexible and to move with the

times. It will take into account the unprecedented nature of the current environment and the surrounding circumstances, for example the availability of government loans and other relief. The other side of the coin is that a director who seeks to use the situation for his own benefit, for example to extract money from the company where that is not justified, cannot hide behind current situation.

24. The stark reality is that most directors will be doing what they can to hold the ring pending an uncertain outcome; that is not a breach of duty. For self-protection a director should record his decision making process and the reasoning behind it.

Light touch administration

25. This is a process which has emerged in the last couple of months. It is worth remembering that in *Re Angel House Developments Limited* [2018] EWHC 766 (Ch) Mr Justice Snowden approved a 'light touch' administration where the administrators were not heavily involved in the day-to-day running of the business, instead relying from the outset of the administration on employed property agents to manage the operational aspects of the continuation of the business. The Judge concluded the light touch administration was appropriate in the circumstances. However, that was in the context of the purpose of the administration being for the benefit of the charge-holder.

26. It is again helpful to look at the test applied by the court in breach of duty cases brought against office holders. The test to be applied in deciding whether there has been a breach of duty was set out by Millett J in *Re Charnley Davies Ltd (No 2)* [1990] BCLC 760 where he said:-

'It follows that the administrator is to be judged, not by the standards of the most meticulous and conscientious member of his profession, but by those of an ordinary, skilled practitioner. In order to succeed the claimant must establish that the administrator has made an error which a reasonably skilled and careful insolvency practitioner would not have made.'

27. An office holder is given a wide degree of discretion in carrying out his functions and will not be criticised unless it can be shown that he took or failed to take some action a reasonably competent office holder would have taken or not taken: *Oraki and (2) Oraki v (1) Bramston and (2) Defty* [2015] BPIR 1238.

28. The current administration of Debenhams is intended to be a light touch, explained by Justice Trower [2020] EWHC 921 (Ch),

"…the Administrators (Mr Geoff Rowley) explained that the Administrators are intending to conduct what he called "a 'light touch' administration which would protect and retain value in the business, reduce new money funding requirements and maximise options for exiting the administration as a going concern". To that end the Administrators' proposals currently include consenting to the exercise of certain operational powers by the current management and working with them to stabilise the business during the COVID-19-related uncertainty. They also propose continuing to pay suppliers that are critical to the online business on the basis that this is currently the sole source of revenue and helps to maintain value in the brand."

29. There was no criticism of this proposed course of action. Indeed he agreed with the comments made by Snowden J in *Re Carluccio's Limited* [2020] EWHC 886 (Ch):

"The COVID-19 pandemic is a critical situation which carries serious risks to the economy and jobs in addition to the obvious dangers to health. I think that it is right that, wherever possible, the courts should work constructively together with the insolvency profession to implement the Government's unprecedented response to the crisis in a similarly innovative manner."

30. Therefore, in looking at the conduct of an administrator the court will look at the surrounding circumstances and any innovative way, with the profession, to adapt to the critical situation in which we find ourselves. It follows that a prospective office holder needs to be careful in a light touch administration to ensure that checks and balances are in place, but subject to that the process should not be a cause for concern.

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