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THE CORPORATE INSOLVENCY AND GOVERNANCE BILL 2020

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WRONGFUL TRADING: DAMP SQUIB?

LINDEN IFE

Biography

Linden was nominated by the Legal 500 as its Insolvency Junior of the Year in both 2020 and 2019. She is ranked there and in Chambers & Partners as a leading junior in Restructuring and Insolvency, Company, Commercial Chancery, and Commercial Litigation. Recent quotes in these directories include:

"She is a tour de force and cuts through the issues in a case very easily. She is dynamic, personable and brings spades of immediate reassurance to clients"

"She is a superlative advocate"

"Intellectually speaking, she's frighteningly quick but most importantly she is a very persuasive advocate. I've seen her turn judges around"

"A formidable trial advocate with excellent technical knowledge. She inspires trust and confidence in lay clients and gets to the nub of issues quickly and effectively. Her written opinions are clear and decisive"

"There's simply no one better at cross-examination. She's very accessible to her instructing solicitor and has a fast turnaround on papers. She's a hugely impressive advocate who really gets the judge on side"

"An excellent advocate who brings the judges round to her way of thinking. She is very clear, to the point and great with clients".

She is a regular speaker at conferences for the ILA, R3 and the Chancery Bar Association.

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Wrongful trading

Introduction

1. At the end of March, the Business Secretary, Alok Sharma, said at a Downing Street press conference that the much-heralded new Bill would give companies the time, space and flexibility to "weather the storm" of coronavirus, and "emerge intact the other side".

2. The Corporate Governance and Insolvency Bill was published on 20 May. It will have its second reading on 3 June; there was widespread consultation before the first reading, so it is unlikely to change very significantly, and it is currently expected to become law before the end of June.

3. In fact, some of its provisions were not created as a response to the crisis, but had been discussed by insolvency lawyers and practitioners for several years. Administrations have not turned out to be quite as successful at rescuing companies as was expected, because they are frequently used as a way of selling the company's business and then killing off the company. The new provisions therefore divide into temporary provisions to deal with the crisis, and permanent ones to assist with company rescue generally:

   (1) Temporary provisions (which have retrospective effect from 1 March to 30 June or one month after the Bill is enacted, whichever is the later, and are extendable), which are:

      a. Suspension of directors' liability for wrongful trading
      b. Prohibition on presentation of winding-up petitions from 27 April, unless the creditor can show that coronavirus has not worsened the financial position of the company

c. Provision for the holding of company meetings electronically, even if the company's constitution does not allow for this
d. Extension of time for filing documents.

(2) Permanent provisions, which are:

a. Introduction of new moratorium – a short term debtor in possession restructuring process, with monitoring and court oversight
b. Introduction of new restructuring scheme, including "cross-class cram down" i.e. forcing dissenting classes of creditors to be bound by it
c. Nullifying of clauses in supply contracts providing for termination of the contract on insolvency (with a *temporary* exemption for small company suppliers).

4. In this short talk I will summarise the new temporary wrongful trading provisions, and the permanent ones concerning supply contracts. I will also touch on the permanent new restructuring scheme.

Suspension of directors' liability for wrongful trading

5. Generally the new Bill is to be welcomed, as providing new ways of enabling distressed companies to take stock, restructure if necessary, and survive. However, the new provision concerning wrongful trading is a bit of a mess.

6. Section 214 of the Insolvency Act 1986 famously contains no definition of what is generally known as "wrongful trading", which has led to some confusion in some of the commentary I have seen over what is actually being suspended under the Bill. S.214 applies only to companies which

have gone on to insolvent liquidation or administration. It says, in summary, that if a director becomes aware, or ought to have become aware, that there was no reasonable prospect of the company avoiding insolvent liquidation or administration, then s/he may be ordered to make a contribution to the company's assets, *unless* s/he takes every step to minimise the potential loss to the company's creditors as s/he ought to have done.

7. The reason why s.214 is headed "Wrongful trading", despite there being no reference to "trading" in the section, is of course that directors will most commonly become liable under it if, despite knowing (or being in a position where they ought to know) that there is no real prospect of avoiding liquidation, they fail to seek insolvency advice from a qualified practitioner, and carry on trading, incurring further debts and leading to an increase in the deficit to creditors when the inevitable happens. It may also happen through the directors allowing the company's assets to be depleted.

8. If they do wrongfully trade, and liquidation or administration ensues, then the amount of the contribution which the director may be ordered to make is in the court's discretion. However, the jurisdiction is compensatory rather than penal (*Re Produce Marketing Consortium Ltd (No.2)* [1989] BCLC 520), and the contribution ordered will normally reflect the amount by which the deficit to creditors increased as a result of the wrongful trading. This usually involves looking at the period from when the director should have realised that there was no reasonable prospect of avoiding insolvent liquidation or administration, and working out how much the deficit increased during that period.

9. What the new Bill does, in section 10, is to say that in assessing the contribution, the court must assume that the director is not responsible for any worsening of the company's financial position (or that of its creditors) during the period of 1 March until one month after the Bill is

enacted. So that period must be excluded from any calculation. And that is all the Bill does in this area.

10. The purpose of s.10 (which does not apply to insurance companies, banks, and other financial institutions) is to help directors trade the company through the coronavirus crisis by removing the threat of personal liability if they do not take every step with a view to minimising the potential loss to creditors (by, for example, continuing to incur new debts). It is to be assumed by the court that they are not responsible for any worsening of the position during the relevant period.

11. But the question of what contribution to order, which is all that s.10 is concerned with, expressly does not arise under s.214 until the court has already found that the director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation or administration. And if the court has already found that the company never had any reasonable prospect of surviving (whether due to coronavirus or not) and the director should have known that, then why should the director be relieved from liability for not protecting creditors? If the director can say that s/he reasonably thought that the problems were temporary and due to the crisis, and that there was a reasonable prospect of the company trading through the difficulty, s/he will not be liable for wrongful trading under s.214 anyway, without the new provision.

12. So the new wrongful trading provisions are unnecessary to save a company with a reasonable prospect of surviving the coronavirus crisis. Nevertheless, it might be argued that directors' perception of the risk of personal liability will be changed by the new Bill, and they will be more willing to try to nurse the company through the crisis, rather than rushing to insolvent liquidation or administration for fear of personal liability. Well, not exactly. I would make two points about this:

(1) Seeking insolvency advice at an early stage is to be encouraged, even if the directors believe the company can trade through, especially given the new moratorium and restructuring options elsewhere in the Bill. They should not think that by taking insolvency advice, they are dooming the company to liquidation or administration. And if the insolvency professional then advises that there is no real alternative to liquidation or administration, the directors should follow this advice, and not continue to trade

(2) More significantly from the directors' point of view, they are not relieved by the new s.10 from their usual duties. These include, where a company is insolvent or close to insolvency, a duty to give paramount consideration to the interests of creditors, and to preserve the business and assets of the company; it is obvious that there is a hefty overlap with wrongful trading here. Damages for breach of that duty will *prima facie* represent the amount of loss caused to the company by the breach, which is the same as for wrongful trading. Will a director be able to claim relief from liability for breach of duty under s.1157 Companies Act 2006, on the ground that s/he acted honestly and reasonably (in the light of the crisis) and ought fairly to be excused from liability? It has already been held that directors cannot rely on this section to avoid wrongful trading liability under s.214, because the tests are different (*Re Produce Marketing Consortium Ltd (No.1)* [1989] 1 WLR 745). But can they do so where they would have been liable (because they knew or should have known that the company could not avoid insolvent liquidation or administration) but for s.10 of the Bill, and now face a claim for breach of duty? On the authority of *Re Produce Marketing Consortium Ltd (No.1),* they should not

be able to do so. Frankly, the indirect effect of s.10 of the new Bill on liability for directors' duties is clear as mud; but Parliament cannot have intended (presumably) that directors could, despite s.10, be liable for wrongful trading by the back door of a breach of duty claim. Directors should nevertheless be advised carefully to record their decisions, and the reasons for them, in minutes, emails or other documents. Of course, the best thing they can do is to take advice from professionals early on if the company is in difficulties, both because this will be in the interests of the company, and to protect themselves.

13. A further question is whether the assumption that the court is required by s.10 to make (that the director is not responsible for any worsening of the financial position during the relevant period) is rebuttable by evidence to the contrary. Legal presumptions usually are rebuttable, but the Bill is currently silent about this. The Explanatory Notes published with the Bill state that s.10(1) "sets out that the court *will not* [my italics] hold a director responsible for any worsening of the financial position of the company or its creditors during the relevant period", which does not suggest that it is rebuttable.

14. It could not anyway be rebuttable simply by evidence that the director permitted the company to trade despite knowing that that it was bound to go into liquidation, because that is expressly the wrongful trading scenario in s.214 from which s.10 gives him or her immunity. It may be that if a director did something during the relevant period which was completely outside the company's normal trading pattern, which caused a loss, then this ought to be sufficient to rebut the presumption that s/he was not responsible; such an unusual transaction might well be a preference or a transaction at an undervalue anyway, and these are not affected by the new Bill.

15. Finally it should be noted that if the company's future descent into liquidation or administration was or should have been obvious *prior* to 1 March, and the director failed to every step to minimise losses to creditors, then s/he will still be liable for any worsening in the company's position prior to that date. Because of the new provision, however, that liability will not extend to losses incurred *after* 1 March. It is not clear, in those circumstances, why this should, or should always, be so.

Nullifying of clauses in supply contracts providing for termination of the contract on insolvency

16. These are also known as "ipso facto" clauses; they are very common in supply contracts, and provide the supplier of goods or services with the ability to terminate the contract (or, sometimes, provide for the contract to terminate automatically) if the company goes into an insolvency procedure such as administration; which therefore makes it more difficult to rescue the company. Restrictions on their operation already exist in relation to utilities and IT suppliers; the Bill imposes restrictions on all suppliers (except, temporarily, small suppliers – see below). These provisions of the Bill do not apply to suppliers involved in the provision of insurance services, or banking or other financial services.

17. Section 12 of the Bill introduces a new section 233B into the Insolvency Act 1986, providing that where a company goes into any one of various insolvency procedures (including liquidation), or enters into the new style moratorium also provided for in the Bill, any such clause ceases to have effect; as does a clause in the contract providing that "any other thing would take place" (such as an increase in prices).

18. Further, where the supplier is entitled to terminate the contract or "do any other thing" because of an event which occurred before the start of

the insolvency procedure, and that entitlement arose before the start of the period, the entitlement cannot be exercised during the insolvency procedure. Accordingly a supplier who has an entitlement to terminate the contract for a ground other than insolvency, and also suspects the company of impending insolvency, would be well advised to terminate promptly on the other ground if it wishes to do so, because once the company enters an insolvency procedure, it will not be able to terminate on any ground until the procedure is at an end.

19. Nor can the supplier make it a condition of continuing supply during the insolvency procedure that it be paid outstanding sums.

20. There are exceptions to these provisions where:

    (1) the company or officeholder consents to the termination, or

    (2) the court is satisfied that the continuation of the contract would cause the supplier hardship, and grants permission for termination. It is not clear what will constitute sufficient hardship to satisfy the court, but clearly the purpose of the section is to aid the rescue of insolvent companies, and that is not going to be promoted by sending suppliers into insolvency as a result.

21. Further, s.13 of the new Bill introduces a temporary exclusion for small suppliers. Where the insolvency occurs between 1 March and the 30 June or end of one month from the enactment of the Bill, whichever is later, the new provisions do not apply to "small entity" suppliers as defined (the definition is by reference to any two of the following conditions being satisfied: turnover of no more than £10.2m, balance sheet total assets of no more than £5.1m, and number of employees no more than 50. These criteria are adjusted if the company is in its first financial year).

New restructuring scheme

22. This is a brief resumé of the new restructuring scheme which is introduced by Schedule 9 of the Bill, by inserting new ss.901A to 901L of the Companies Act 2006. The new scheme is most likely to be useful for complex debt restructuring with several creditor classes.

23. The new scheme is intended to be more useful for companies than the existing scheme of arrangement provisions, by creating what is known as "cross-class clam down" provisions: i.e. the ability to bind one or more dissenting classes of creditors or shareholders.

24. Companies or their creditors can propose a "compromise or arrangement" between the company and its creditors and/or shareholders. Creditors and shareholders are required to vote in classes: each class will be deemed to approve if 75% in value of each class vote in favour, and there is no requirement that a majority in number vote in favour, as there is with current schemes of arrangement.

25. The new scheme must be sanctioned by the court as being just and equitable (unlike a CVA).

26. Any company which is liable to be wound up under the Insolvency Act, including a foreign company, can be the subject of a new scheme, provided:

    (1) it has encountered, or is likely to encounter, financial difficulties which affect, or may affect, its ability to carry on business as a going concern

    (2) the purpose of the compromise or arrangement is to eliminate, reduce, prevent or mitigate the financial difficulties.

27. The scheme can bind one or more dissenting classes of creditors (cross-class cram down), but:

    (1) the court must be satisfied that none of the members of the dissenting class would be worse off under the compromise or arrangement than the "relevant alternative", i.e. what the court considers would be most likely to occur if the compromise or arrangement is *not* sanctioned

    (2) The compromise or arrangement must have been approved by at least one class of shareholders or creditors, and that class must be going to receive a payment or have another genuine economic interest in the company in the event of the relevant alternative.

28. There are some exceptions to these principles: e.g. if the new scheme is proposed within 12 weeks of a new moratorium, debts incurred during the moratorium and pre-moratorium which do not have a payment holiday, e.g. finance creditors, cannot be compromised without consent, which means that finance creditors can object to the new scheme where there has been a new moratorium under the Bill.

29. This represents quite a shift in balance of power from senior to junior creditors, provided that the court is satisfied that the dissenting class would not be worse off under the scheme than if it were not sanctioned, which will involve significant speculation as to what would happen if it were not.

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