Suspension of liability for wrongful trading

Updated as of 21 May 2020

Wrongful trading

In the ordinary course, a director has a duty to act in the best interests of the company's shareholders; or as the Companies Act says, *he must act in the way he considers in good faith would be most likely to promote the success of the company for the benefit of its members as a whole*. In order to a turn a profit for the shareholders, a director may be expected to take some level of risk with the company's assets.

Where a company gets into financial trouble, the directors will need to consider not just the interests of the company's shareholders, but also the interests of the company's creditors. If the company's position worsens further, there will come a point in time when the directors realise that the company will become insolvent or will need to go into administration; or as the Insolvency Act says, a time when the directors *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*. If a director allows the company to carry on trading after that point of time and the company does indeed go into insolvent liquidation or administration, a court may make an order against such a director, declaring that he is liable to make a contribution to the company's assets in order to help pay the creditors. A court may not make such an order if, once the director knew the company could not avoid insolvency, he *took every step with a view to minimising the potential loss to the company's creditors*. In practice, this means that a director should not take a risk and carry on trading in the hope that the company might earn some profits with which to repay its creditors; instead the company should immediately cease trading so as to stop losses increasing. Carrying on trading after the point of no return is known as "wrongful trading". Where a company becomes insolvent, or liable to become insolvent, the directors will at that stage have a duty to act in the interests of the company's creditors, rather than its shareholders.

Covid-19 emergency

As the Covid-19 emergency developed and the lock-down came into operation, it became apparent that many companies were likely to encounter short-term cashflow difficulties. If the cash runs out, a company will go into insolvency, even if its underlying long-term business is sound. The perceived risk was that directors of large numbers of companies, mindful of their potential liability for wrongful trading and the growing financial uncertainties ahead, might feel forced to pull the plug on their businesses, leading to a rapid escalation of the financial crisis. On 28 March 2020 the Government announced that it would introduce legislation to temporarily suspend the wrongful trading laws. On 20 May 2020 the Government published the Corporate Insolvency and Governance Bill.

Proposed legislation

The Bill provides protection for directors during a grace period of 1 March to 30 June 2020 (or one month after the legislation comes into force, whichever is the later) – this is known as the ''relevant period''. The Bill states that *in determining the contribution (if any) to a company's assets that it is proper for a person to make, 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*. So a director will not increase his potential personal liability for wrongful trading by allowing the company to trade during the relevant period.

The suspension of liability for wrongful trading does not apply to certain companies in the financial services industry, such as insurance companies, banks and investment firms.

Comment

As drafted, the respite for directors is limited: they will remain liable for losses which may arise after the end of the relevant period. The possibility exists that, in the second half of June, a number of companies which had been able to put off the decision to stop trading may find themselves having to re-consider that decision.

Also, the Bill does not alter the underlying law which requires a director of a company which is insolvent, or liable to go into insolvency, to act in the interests of its creditors rather than its shareholders. Accordingly, although the directors of a distressed company may be able to continue to trade during the relevant period, they will need to conduct the company's business in the interests of its creditors.

For more information on directors' duties please refer to our guidance note on this subject.

For more guidance, and further information, visit our Coronavirus hub.