Changes to UK Insolvency Rules in the Wake of Covid-19: A Much-Needed Help for Businesses or an Unjustified Harm to the Rule of Law?

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Abstract
The economic impact of the Covid-19 outbreak has triggered calls for emergency fiscal and legislative measures to address liquidity and legal problems in several areas of law. Some of these measures address specifically companies in financial distress and insolvency statutes. Among the proposed changes to the insolvency framework, the UK Government announced a suspension of wrongful trading provision as outlined in section 10 of the Corporate Insolvency and Governance Bill (‘the Bill’). This measure applies retrospectively from 1 March 2020 for a 3-month period or one month after the coming into force of the Bill, whichever is later.

To assess the need for such a measure, this paper investigates the requirements to establish a successful claim for wrongful trading and the interpretation of those requirements, stemming from the case law. It also discusses the announced suspension as implemented by the Government in the Bill. This analysis strongly suggests that the suspension of (liability for) wrongful trading does nothing to achieve the purpose for which it was introduced, i.e. to facilitate business rescue and/or to help viable companies to survive the crisis created by the Covid-19 pandemic.

To the contrary, the suspension of personal liability actions against the directors is likely to curb the rule of law in the UK. Laws are deferred and the exercise of civil liability remedies restricted without any apparent justification and with no proof that this measure is relevant to address the crisis created by the Covid-19 pandemic.

I. Introduction
The economic measures announced and implemented by the Government in the past few weeks to deal with the immediate and long-term consequences of the Covid-19 outbreak are broad-ranging.¹ Some aim at keeping companies afloat by furloughing employees under the Coronavirus Job Retention Scheme,² granting emergency loans, deferring VAT

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² Under the Coronavirus Job Retention Scheme, companies can put their employees on furlough because of the restrictions on trade arising from the Covid-19 pandemic. In that case, the Government will pay 80 per cent of the employee’s wages plus any employer National Insurance and pension contribution up to £2,500/month: <https://www.gov.uk/guidance/claim-for-wages-through-the-coronavirus-job-retention-scheme> accessed 25 April 2020. Unfortunately, despite the detrimental effect that this may cause for the possibility of rescuing the company in administration, the courts have held that if the employees remained
payments and stopping the requirement to pay taxes on property leases.\(^3\) Others avoid that insolvency procedures are brought against companies that are only temporarily cash-flow insolvent due to the Covid-19 outbreak.\(^4\)

On Saturday 28 March 2020, the Business Secretary, Alok Sharma, announced new insolvency measures to provide businesses with the flexibility and breathing space they need to continue trading during the Covid-19 crisis.\(^5\) This announcement later resulted in the Corporate Insolvency and Governance Bill (‘Bill’),\(^6\) which is expected to be converted into law by the end of June 2020. The most prominent of the proposed changes to the insolvency framework are:

1. A temporary suspension of liability for wrongful trading;
2. A short automatic stay for companies giving them a breathing space from creditor action, whilst they seek rescue or restructure;
3. Allowing companies continued access to their supplies; and
4. A new restructuring plan which would be binding on all creditors and include a “cross-class cram down”.\(^7\)

This paper focuses on the announced suspension of wrongful trading provision as later implemented in the Bill. To assess the need for such a measure, this paper investigates the requirements to establish a successful claim for wrongful trading, taking into account the interpretation of those requirements established from the case law. This analysis suggests that suspension of (liability for) wrongful trading does nothing to allow directors to protect viable businesses struggling from the Covid-19 pandemic from vulture creditors.

To the contrary, the suspension of personal liability actions against the directors has the effect of promoting abusive exercise of powers by directors, thus reducing the rule of law in the UK and restricting the exercise of civil law remedies by the company’s creditors.

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\(^3\) See, for instance, the provisions made in the Coronavirus Act 2020 (which received Royal Assent on 25 March 2020), preventing landlords from exercising a right of forfeiture of a relevant business tenancy (under Part 2 of the Landlord and Tenant Act 1954) for non-payment of rent between 25 March and 30 June 2020 (a date which may be extended).


\(^6\) Corporate Insolvency and Governance HC Bill (2019-21).

\(^7\) “Cross-class cram down” is a prominent feature of the US Chapter process. Usually, a restructuring plan can only be approved if the required majority of creditors vote in favour of it. If creditors are divided in classes, all classes need to reach the required majority but dissenting creditors within that class are out-voted by the other creditors within the same class. If cross-class cram down is allowed, dissenting classes of creditors can be out-voted provided that the other classes vote in favour of the restructuring plan. The cross-class cram down needs to be sanctioned by a court so long as it does not unfairly prejudice the dissenting class of creditors.
II. Wrongful Trading under English Law – A Look at the Statutes

The wrongful trading section of the Act applies whenever the company directors did not take appropriate actions and caused damage to the creditors by continuing to operate a company when they knew or ought to have known that the company had no reasonable prospects of avoiding insolvent liquidation or administration.\(^8\)

The introduction of a similar provision was strongly recommended by the Cork Report,\(^9\) as there was the perception that the burden of proof required to establish fraudulent trading (criminal liability) was too high to prevent the inappropriate behaviour of the directors.

This section is without prejudice to sections 213 and 246ZA of the Act, which deal with fraudulent trading.\(^10\)

The petition can be submitted not only by the liquidators, but also by the administrators.\(^11\)

The consequences for the alleged perpetrator are not only to make a contribution to the assets of the company but also to be subject to disqualification proceedings.\(^12\)

To establish civil liability, the petitioner (administrator or liquidator) needs to demonstrate that:

1. There was a specific moment in time before the director filed for liquidation or administration when the directors realised that a formal insolvency proceeding was inevitable (“point in time”); 
2. The director, de facto director and shadow director\(^13\) knew or ought to have known that there was no reasonable prospect of the company avoiding going into insolvent liquidation or administration (“director’s knowledge”); and 
3. The wrongful trading caused an increase in the company’s net deficiency (“damage”).

To assess the director’s knowledge, section 214(4) of the Act introduces a test which is both objective and subjective (“moment of truth” test). Accordingly, what is being assessed is whether a director knew or ought to have known that there was no prospect of avoiding insolvent liquidation or administration if such outcome would be reached by:

(a) Any director with general knowledge, skill and experience; and 
(b) The specific director, with his or her specific knowledge, skill and experience.

If it is proven that the director continued trading after they knew or ought to have known that there was no reasonable prospect of avoiding insolvent administration or liquidation, there is a case of wrongful trading.

\(^8\) s.214(1) IA 1986.  
\(^10\) s.214(8) IA 1986. For more on this matter, see section III(a) of this paper. 
\(^11\) s.246ZB IA 1986. 
\(^12\) s.215(2) and (4) IA 1986. 
\(^13\) s.214(7) IA 1986.
Directors can only escape liability for wrongful trading if they demonstrate — on the balance of probabilities — that they took every step with a view to minimising the potential loss to the company’s creditors.\textsuperscript{14}

This preliminary analysis of the statutory requirements to establish a successful claim for wrongful trading suggests that directors would have a hard time in shielding themselves from such claims. The office holder needs only to establish that the debtor was approaching insolvency and the director continued trading, thus causing a financial loss to the creditors.

It appears, therefore, that the Government’s decision to suspend this provision facilitates business rescue and helps viable companies to survive the crisis created by the Covid-19 pandemic. However, one should exercise caution when making such assumption, especially because — as mentioned before in this section — the directors remain liable for a multitude of other offences under the Act.

The next part of the paper considers whether the Government’s decision to suspend this provision stands up to scrutiny, when considered in light of how courts have interpreted this section of the Act and the statutory language in the Bill.

\section*{III. Wrongful Trading under English Law – A Look at the Cases and at the Bill}

Law in books differs from law in practice. It is, therefore, appropriate to investigate how courts have implemented the statutory provision outlined in the earlier part of this paper and how the suspension of wrongful trading was translated into the Bill.

\textit{a) Case Law}

In order to establish if a director is liable for breaching the wrongful trading provision, the courts consider the specific circumstances of the case. Particularly, they consider the companies run in the past by the director, the type of business and the profile (executive or non-executive) of the director.\textsuperscript{15}

Courts do not approach the question of whether a director ought to have concluded that a company had no reasonable prospect of avoiding liquidation with the benefit of hindsight, i.e. on the basis of \textit{ex post} knowledge.\textsuperscript{16}

One of the most contentious points of the wrongful trading provision has always been the defence provided by section 214(3) of the Act. Directors can invoke this defence if they took every step to minimise the potential loss to the company’s creditors.

Proof that they have met the requisite conditions set out in section 214(3) can be reached if the director demonstrates that the continuation of trading was intended to reduce the net deficiency of the company and minimise the risk of loss to individual creditors.\textsuperscript{17}

\textsuperscript{14} S.214(3) IA 1986.
\textsuperscript{17} Re Ralls Builders ltd [2016] EWHC 243 (Ch), [2016] B.C.C. 293.
In *Continental Assurance*, the directors escaped liability because they reduced trading to minimal and cautious levels and filed for liquidation when they were advised that the company was insolvent.\(^{18}\) And, vice versa, the directors did not escape liability in *Idessa*, as they did not take appropriate measures to reduce the company’s cash flow and minimise the losses for the creditors.\(^{19}\)

While this defence in section 214(3) has been successfully invoked in the past, it is also undeniable that it had been construed strictly,\(^{20}\) in order to avoid making it too easy for directors to escape liability. Additionally, courts have usually adopted a tough stance on directors.\(^{21}\)

Overall, this may give even more credence to the suggestion that the Government’s decision to introduce a suspension to this provision is appropriate to ensure that viable companies continue trading over the Covid-19 crisis. A law tough on directors has been applied strictly by the courts. Law in books and law in practice seem not to differ, at least at first glance.

Nevertheless, it is to be noted that, even if the section 214(3) defence fails, courts have complete discretion as to whether to make an order and if so, on its content. For instance, in *Nicholson* the court declined to make a declaration that the company’s directors were liable for the losses caused by wrongful trading despite the fact that the applicant succeeded in proving the misconduct and the defendant failed in their defence. This is because the debtor was operating in challenging market conditions (the period following the Global Financial Crisis of 2007-08), in a sector of the economy significantly affected by the said challenging conditions. Additionally, the directors constantly monitored and discussed the situation with key creditors.\(^{22}\)

The court’s discretion may suggest that there is no real need to introduce a suspension of this provision due to the Covid-19 pandemic. Furthermore, there are other factors militating against the need to introduce such a suspension into the law.

First, in any wrongful trading application, the applicants need to prove that the company had “no reasonable prospect” of avoiding insolvency. This represents a challenging and daunting task in the current economic and financial climate. At the time of writing, the Government announced that the lockdown should have remained in place for 3 weeks.\(^{23}\) Subsequently the Government extended this period for another 3 weeks\(^{24}\) and it only on 23 April acceded to a request to outline an exit strategy from “phase 1” of the Covid-19

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\(^{19}\) *Re Idessa (UK) ltd*[2011] EWHC 804 (Ch), [2011] B.P.I.R. 957.


\(^{21}\) See, among others, *Palmer v Tsai*[2017] EWHC 2710 (Ch), [2017] 9 W.L.U.K. 369, where the court refused to grant additional time to directors to file their defences as they had already failed to comply with previous court orders.


\(^{23}\) On 23 March 2020, the Government announced measures to stem the coronavirus pandemic. These included a ‘lockdown’: citizens should now stay at home apart from essential travel or risk fines and all non-essential shops were to close; H Stewart and others, ‘Boris Johnson orders UK lockdown to be enforced by police’ *The Guardian*, 23 March 2020.

\(^{24}\) BBC, ‘Coronavirus: UK lockdown extended for ‘at least’ three weeks’, 16 April 2020.
crisis. If directors do not know when their companies will be allowed to operate again in the market and under which conditions, they cannot assess if their companies have no reasonable prospect of avoiding insolvent liquidation or administration. Hence, office holders cannot successfully promote a claim for wrongful trading against them. It follows that there is no apparent reason for the Government to suspend the enforceability of this section in the wake of the Covid-19 crisis.

Other reasons militate against the introduction of a suspension of wrongful trading.

Second, this suspension is not a panacea. Directors continue to be liable for the breach of the duties they have towards the creditors; fraudulent trading and transactions defrauding creditors; antecedent transactions which put assets beyond the reach of creditors; and misfeasance.

As the wrongful trading section is not the only means by which directors may incur personal liability for their actions, suspending this provision alone will not remove the risk of personal liability for directors. This in itself suggests that the announced protection against personal liability granted to directors by means of the suspension of wrongful trading is partial at best.

Third, courts also retain discretion not only with reference to the wrongful trading order but also in determining if the company is cash-flow insolvent. The existence of a condition of insolvency or inability to pay its debts is a key issue for triggering a wrongful trading claim.

On this latter point, in the seminal case of Cheyne Finance, the court held that they will not adopt a “blinkered” review based on a slavish focus on the debts due at the relevant date. In other words, English courts will not declare a company “insolvent” if the inability to pay its debts is due to a temporary lack of liquidity soon to be remedied. This position was approved by the UK Supreme Court in Eurosail.

The Eurosail approach is being generally applied by the courts. As a result, it is nowadays possible to claim that the words “as they fall due” in section 123(1)(e) of the Act transform the cash-flow test into a flexible and fact sensitive requirement to which balance-sheet insolvency is not irrelevant. The analysis of cash-flow insolvency shall not be carried out mechanistically but in a manner that has regard to commercial reality.

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25 R Merrick, ‘Coronavirus: Government finally reveals lockdown ‘exit strategy’ with plan to recruit 18,000 to trace infected people’ The Independent, 23 April 2020.  
26 ss. 171-177 Companies Act 2006.  
27 It is still uncertain the exact moment in time in which creditors’ interests have to be considered by the company’s directors.  
28 s.213 IA 1986.  
29 s.423 IA 1986.  
30 ss. 238-239 and 244-245 IA 1986.  
31 s.212 IA 1986.  
32 Re Cheyne Finance plc (No 2) [2007] EWHC 2402 (Ch), [2008] Bus. L.R. 1562.  
33 Ibid [51].  
Fourth and finally, courts have consistently held that “to put a company into administration is a serious matter”\textsuperscript{37} and should be restricted to cases where rescue is possible\textsuperscript{38} and the debtor is more likely than not to be insolvent.\textsuperscript{39}

The third and fourth points reassert that – especially during the Covid-19 crisis – office holders will have a hard time to prove that the company had no reasonable prospects of avoiding insolvent liquidation or administration. This suggests, once again, the lack of justification to suspend wrongful trading.

\textit{b) The Bill}

Despite the sensible approach adopted by courts in interpreting section 214 of the Act and the existence of other instances of personal liability in the Act, the Government thought it appropriate to introduce changes to the wrongful trading regime to avoid unnecessary insolvencies and allow distressed yet viable companies to continue trading during the crisis. Section III(a) demonstrated that this decision does not withstand academic scrutiny. It is yet to be assessed, however, whether the suspension provision affords directors the protection from wrongful trading actions which the Government intended to give. This section carries out this assessment with reference to the wording of the Bill.

A close look at the provision in the Bill suggests that the announced measure presents several issues, particularly with reference to its scope which at times appears too narrow and other times too broad.

The scope is arguably too narrow. Sections 10(3) and (4) of the Bill clarify that the suspension of liability for wrongful trading does not apply to a variety of companies. These include (among others) insurance companies, banks (including investment banks and firms), building societies, friendly societies, credit unions, public-private partnership project companies and overseas companies with corresponding functions. In other words, a lot of medium and large enterprises are excluded from the scope of this provision without any apparent justification.

Additionally, the Government decided to waive the \textit{liability} for wrongful trading, while section 214 of the Act continues to apply. Furthermore, the liability for wrongful trading for \textit{petitions} but only for \textit{debt} (“worsening of the financial condition”) incurred in the relevant period.

This means that a company can be admitted into insolvency proceedings as a result of the Covid-19 pandemic\textsuperscript{40} and directors can still be sued for breach of section 214 of the Act. As a result, petitioners can still hold directors liable for debt incurred \textit{before} 1 March 2020 if the criteria summarised above are met.

\textsuperscript{37} \textit{Re Colt Telecom Plc (No 2)} [2002] EWHC 2815 (Ch), [2003] BPIR 324 [24]. See also: \textit{Re Gigi Brooks ltd} [2015] EWHC 961 (Ch), [2015] 2 W.L.U.K. 736, where the court declined to make an administration order because it could not be satisfied that the company was insolvent, either on a balance sheet or cash flow basis, or that the statutory purposes would be achieved.

\textsuperscript{38} \textit{Re Arrows ltd No. 3} [1992] BCLC 555, dismissing a petition for administration because the majority of the creditors appeared to be against such an order, thus making it unlikely their approval of the administrator's plan.

\textsuperscript{39} \textit{Re Colt Telecom Plc (No 2)} [2002] EWHC 2815 (Ch), [2003] BPIR 324 [25].

\textsuperscript{40} Exceptions and exclusions apply.
Furthermore, the poor drafting quality of the Bill has the effect of further narrowing down the scope of the suspension. As a result, it is argued that directors may be held accountable for breach of wrongful trading provision even for debt incurred after 1 March 2020 for the reasons outlined below.

The Explanatory Notes seem to grant adequate protection to directors. They state that courts will not take into account losses incurred during the period in which businesses were suffering from the impact of the pandemic. This is not, however, reflected in the language used in the Bill.

Section 10(1) of the Bill provides that 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. From a director's perspective, there would appear to be the risk of an insolvency practitioner being able to rebut that assumption in the course of an action for wrongful trading.

This raises a number of issues. For instance, does the presumption in section 10(1) of the Bill leave it open to an office holder to seek a contribution where they can, through evidence, demonstrate that the person was responsible for the worsening position? On the basis of the current draft of the Bill, the answer is likely going to be in the affirmative.

The narrow scope of the suspension means that it does not apply with reference to some companies and – even with reference to the companies for which it applies – directors can still be held liable for losses incurred before and after 1 March 2020 as a result of wrongful trading.

At the same time, the scope is too broad. First, the provision makes no reference to the pandemic. Other temporary provisions in the Bill refer specifically to coronavirus for the purposes of determining their applicability. For instance, creditors are restricted from serving winding up petitions unless they demonstrated that Covid-19 has not had a financial effect on the debtor. This might be the case, for instant, of an insolvent grocery shop.

However, there is no such qualification to the application of the suspension of liability for wrongful trading provision. Both the Explanatory Notes and the Bill state that there is no requirement to show that the company’s worsening financial position was due to the Covid-19 pandemic. The Bill adopts a blanket approach: liability for losses incurred in the relevant period is waived, irrespective of whether the losses are incurred because of the Covid-19 pandemic.

This blanket approach raises issues of potential abuse of the law if the office holders cannot hold the directors accountable for losses that are not caused by the Covid-19 pandemic.

For instance, the creditor of the above-mentioned insolvent grocery shop may be able to file an insolvency petition against their debtor. This petition is likely to be granted if the

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41 Explanatory Notes to the Corporate Insolvency and Governance Bill 2019-21, para. 28.
42 Section 2(2), Part 2, Schedule 10 of the Bill.
debtor is insolvent for the reason mentioned above. Yet, the office holders may not be able to recover any losses caused by wrongful trading incurred in the relevant period because of the blanket approach of the Bill. This is even if the losses were not caused by the Covid-19 pandemic, thus showing that the scope of the suspension is too broad here.

Second, as stated in section III(a) of this paper, suspending liability for wrongful trading alone will not remove the risk of personal liability for directors. However, the other sections of the Act introduce personal liabilities only for “extreme” cases, such as fraudulent or gratuitous transactions to the detriment of creditors. De facto, section 10 of the Bill introduces a general, too broad shield to personal liability for directors.

Third, this extension is likely to last far longer than the three months originally envisaged by the Government. The Explanatory Notes state that, in the event that the impact of the pandemic on businesses continues beyond the end of that period, the measure may be extended for up to six months using secondary legislation. This process may be repeated, extending the suspension period further.43

As a result of all these considerations, a measure in theory designed to remove the threat of the Covid-19 pandemic on businesses is likely to lift significant restrictions on the arbitrary exercise of powers by rogue directors, thus significantly affecting creditors’ rights (and the rule of law).

c) Concluding Remarks

Wrongful trading already has a relatively high barrier of proof, with very few cases ever taken forward. It already has safeguards which probably would, for most sensible directors, not leave them exposed to risk of personal liability in any given circumstance.

In practice, English courts manage to successfully balance the need to adopt a tough stance on errant directors without unduly compressing their freedom and ability to make rescue attempts on the eve of insolvency. This is especially true whenever directors act under the expert advice of turnaround professionals and accountants.44 As a result, there is no need to introduce a suspension of wrongful trading.

Section 10 of the Bill has altered this equilibrium, unless it is significantly amended as the Bill progresses through Parliament. On the one hand, in some instances this section does not offer protection to directors responsible for worsening of the debtor’s financial position, even if this happened after 1 March 2020 and because of the crisis. On the other, it has the potential of being abused by rogue directors because liability is suspended irrespective of whether the losses are caused by the pandemic. It is sufficient that these losses are incurred during the pandemic (or for a long period of time after 1 March 2020).

As a result, section 10 of the Bill becomes a sort of “Get Out Jail Free” card45 for rogue directors who incurred excessive liabilities at the time of Covid-19. When applicable, it shields them from liability for losses caused by wrongful trading and not due to the Covid-19 pandemic.

43 Explanatory Notes to the Corporate Insolvency and Governance Bill 2019-21, para 29.
45 Wrongful trading is a civil rather than criminal offence. Readers should not be too alarmed by this choice of phrase.
IV. Conclusion

A person who is not expert in insolvency matters may be excused for thinking that the wrongful trading provision represents an unreasonable burden for directors at times of crisis. The same person might be equally excused for thinking that the Government’s decision to suspend the liability rather than enforceability of this provision is “the right one” to save companies and, ultimately, jobs.

But the devil is in the detail. This paper evidences that the Government’s decision does not withstand academic scrutiny. This is because the suspension of liability for wrongful trading is poorly drafted and does not properly consider the law and the way in which courts have consistently interpreted section 214 of the Act.

All these elements strongly suggest that the measure fails to achieve the Government’s goal to remove a deterrence to continue trading where there is a threat of insolvency. It produces, however, undesired side effects. As a result, the announced suspension of liability for wrongful trading may generate a plethora of abusive practices and raise rule-of-law concerns for restricting creditors’ rights without any apparent justification.