

UK Rescue Procedure For Corporate Directors Is No Panacea

By **Howard Morris** (April 7, 2020, 6:32 PM EDT)

Suddenly, prudent managers and risk-averse investors, with envied business models, face going bust. Lenders counted on them as a good risk, suppliers and customers judged them sound and reliable. Now these businesses look like they will be swept away by the pandemic.

Solutions are needed to maintain the sinews of the economy, even if the fat is consumed and the muscle withers. The U.K. government has announced plans to take away the threat to directors of personal financial liability once there is no reasonable prospect that their company can avoid insolvent liquidation, known as wrongful trading.



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There will also be new rules to throw a forcefield around companies to prevent hostile creditor action while the management works on survival. Have we just abolished bankruptcy?

In fact, the government hasn't given directors licence to be reckless. They will still bear onerous responsibilities toward creditors. The new corporate rescue procedure may not be enough to save businesses overwhelmed by the ferocity of the pandemic-induced downturn. But the government has to balance the risks of injury to the economy with making an intervention that makes the economy so sclerotic it struggles to recover once we are past the crisis.

In a capitalist economy, efficient enterprises thrive and acquire the market share and assets of the less efficient. If the less efficient fail to adapt, they don't survive. This Darwinian struggle justifies the rewards the successful receive.

Law dictates the moment at which time is called on a failing business. Rather than continuing to run itself into complete ruin, to avoid a frantic and chaotic rush among creditors and investors to get what they can from the assets of the bust business, the law brings the curtain down on the debtor and applies a process to secure and divide the debtor's assets.

English law, because its history has made it inclined to favor the interests of creditors over debtors in financial crisis, imposes duties on directors of companies to consider the interests of creditors as insolvency looms and not to carry on, like Dickens' Wilkins Micawber hoping something will turn up while allowing the company's assets to fritter away.

In more recent times, legislatures have developed corporate rescue mechanisms. Lawmakers have acknowledged that not all businesses approaching insolvency should simply fail. Parts of many struggling businesses can still be worth saving rather than being devoured in that Darwinian struggle to survive.

Economic efficiency is enhanced where companies can restructure and survive, not to mention the social felicity of preserving a livelihood for employees and the supply chain. Hence, administration and the modern use of schemes of arrangement in the U.K., Chapter 11 in the U.S. and more and more corporate rescue procedures around the world.

The law of insolvency aims to compel directors to act in good time to save them or close their companies rather than carrying on like dear old Mr. Micawber. As soon as a director knows (or ought to know) that there is no reasonable prospect of the company avoiding insolvency, if he doesn't then take every step he ought to minimize the potential loss to creditors, the director is potentially liable for wrongful trading.

Wrongful trading carries with it a personal liability, for which insurance is not available, to top up the assets of the company by the amount those assets have diminished between the moment when the director should have taken every step to minimize potential loss to creditors and the moment when the director actually took those steps.

But we aren't in normal times. Businesses have been closed by government order, competition rules are relaxed to let food retailers cooperate, mortgage lenders are instructed not to enforce, landlords not to repossess, banks not to call defaults, key workers are identified and measures to provide for their support are being put in place, and wages are to be covered by government to keep workers in employment.

We've yet to see the detail but the government has announced that wrongful trading liability will be suspended as of March 1. There will also be a new moratorium procedure for companies while they restructure. It appears the government is going to introduce the reforms to U.K. insolvency law it first proposed in 2016. At the time I called them (I'm sure I wasn't alone) Chapter 11 lite.

We'll have a new rescue procedure giving a debtor company a three-month freeze on hostile creditor action while it puts forward a restructuring plan. During the process, management remains in charge rather than the business being run by an insolvency practitioner (a major break from the past in U.K. insolvency law). There will also be some restrictions on key suppliers terminating contracts by reason of the debtor being insolvent or in an insolvency procedure.

This latest in a series of extraordinary government interventions in the U.K. economy makes it more and more resemble a centrally planned economy. A feature of a centrally planned economy is that there is no need for an insolvency law. Socialist economies didn't allow the market to operate so that enterprises could be compelled to sell assets to meet liabilities or forced into a winding up process.

In the same way, no one could be unemployed and if they didn't have a job, it was because they were an antisocial element with all the consequences that flowed from that. When the Soviet Union broke up, state enterprises couldn't be sold, privatized, because they nearly all owed more than they owned. Because every other enterprise outside the black market was just as bust, there was complete creditor passivity, a gridlock, no one was going to try to end the life of another enterprise because they were in the same position.

If the U.K. economy faces an extended period of keeping zombie businesses in being, we face the same risk of stultifying the economic cycle and will need government intervention, a sort of corporate emetic, to get things moving again.

However tempting, we must not Micawberise every director and not simply because some rogues will be abusing this seemingly consequence-free environment but because free enterprise and its benefits of wealth generation depend on flushing out of the economy the inefficient enterprises. If the new mechanisms make it impossible to filter out and manage the liquidation of companies that have no viable future on any basis, we shall be storing up horrible problems for the future.

In an effort to balance these competing goals, the lifting of the risk from personal liability for wrongful trading isn't, in fact, government permission for every director to become a cowboy. Far from it. Directors have fiduciary duties and onerous responsibilities, and when a company has a more than 50% likelihood of insolvency, the fundamental duty to promote the success of the company is owed to the creditors. The risk of personal liability for a director who doesn't have the interests of creditors as the object of his decisions remains.

The new rescue procedure isn't a panacea. It is short and even if there is a power to extend the moratorium period, it still may not be long enough. Will creditors vote for a restructuring plan that is enough to save the company in an economy collapsing to its knees? They may not be able to countenance the extent of the write off they're asked to take, indeed many of the creditors will themselves be in financial trouble and the rescue of a few debtors will trigger a cascade of further insolvencies.

The U.K. government is not taking the dramatic steps it is in pursuit of a socialist agenda but to ensure the economy is capable of recovery. Weaning businesses off government largesse will be harder the longer the crisis continues. The other obvious problem is that businesses that already ought to fail will be sustained and so we're saving up problems for the future. That's not to say that there is another choice for the government, but this degree of intervention will be addictive and the economy will grow dependent suffering a deep cold turkey when the measures end.

Interrupting the life cycle of capitalism to enable the economy to recover and flourish again is laudable. Dropping the economy into aspic, to shutter it while we fight off the pandemic threat to life will be welcomed not least because without government intervention on an enormous scale, social cohesion is in jeopardy. To make the policy work we must go so far as to protect businesses from liquidation and filter only the most hopeless cases into winding up.

We clearly need to relieve directors of the threat of personal liability so that they aren't deterred from doing all they can to save businesses and jobs but not so that they become reckless. In doing so, we shall, inevitably, enable businesses that are already hopeless to extend their lives at public cost. Moreover, when we have got past this period, we may need more government intervention to kick start the whole capitalist cycle of corporate life and death.

However, by then when we are so steeped in government intervention, will there be the appetite to cut off the means that has kept millions of workers in jobs? We must remember the experience of planned economies is that they fail and this challenge is waiting for us.

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