LATHAM&WATKINS

Client Alert
Commentary

Latham & Watkins Restructuring & Special Situations Practice

23 July 2020 | Number 2674

Visit Latham's COVID-19 Resources page for additional insights and analysis to help navigate the legal and business issues arising from the global pandemic.

COVID-19: UK Government Temporarily Suspends Wrongful Trading Rules to Assist Directors of Affected Companies

The Corporate Insolvency & Governance Act introduces temporary and permanent changes to UK insolvency and restructuring laws.

On 28 March 2020, the UK government announced a number of reforms to UK insolvency laws:

- Temporary suspension of existing wrongful trading rules, in respect of directors' actions for three months beginning from 1 March 2020 (the period has subsequently been extended). The suspension was intended to ensure that directors in this uncertain COVID-19 environment would be able to take decisions to continue to trade and incur new credit — including under the government funding initiatives — 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 (IA86). A summary of existing wrongful trading rules is set out below.

- The same legislation would amend the insolvency regime and introduce new insolvency and restructuring regime procedures. The objective of the changes was to further enhance the "rescue culture" for businesses in the UK and, in a single piece of legislation, to allow potentially strong businesses to survive and hopefully thrive — similar to the US and its chapter 11 process.

Legislation to introduce these changes was introduced in Parliament in May and received Royal Assent in June as the Corporate Insolvency & Governance Act 2020 (CIGA). For a full briefing on the revisions to the insolvency and restructuring landscape brought about by the CIGA, including permanent and other temporary changes, please register for Latham & Watkins' webcast.

The wrongful trading measures do not impact the existing laws relating to, for example:

- Fraudulent trading (s. 213 IA86, and s. 246ZA IA86)

- Transactions defrauding creditors (s. 423 IA86)

- Misfeasance (s. 212 IA86)

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in France, Hong Kong, Italy, Singapore, and the United Kingdom and as an affiliated partnership conducting the practice in Japan. Latham & Watkins operates in South Korea as a Foreign Legal Consultant Office. Latham & Watkins works in cooperation with the Law Office of Salman M. Al-Sudairi in the Kingdom of Saudi Arabia. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2020 Latham & Watkins. All Rights Reserved.

- The general duty of directors to act in the way they consider, in good faith, would be most likely to promote the success of a company for the benefit of members as a whole, or when there is a heightened risk of insolvency, to instead consider or act in the interests of its creditors (s. 172 of the Companies Act 2006)

The above, together with director disqualification laws, continue to apply in order to protect relevant stakeholders from the actions of directors.

So directors will still need to ensure they obtain professional advice in this very difficult trading and economic environment.

Summary of previous wrongful trading provisions

The wrongful trading provisions in the IA86 (s. 214 and s. 246ZB) are concerned with situations in which directors fail to take proper steps to protect creditors when insolvent administration or liquidation is unavoidable. It is these provisions that most commonly lead directors of UK companies to conclude that they need to file for the protection of a formal insolvency process, such as administration or liquidation.

Wrongful trading provisions apply to any person who is or has been a director (including a shadow, de facto, non-executive, and nominee director) of the company in question. If the company is in insolvent administration or insolvent liquidation, any such director will be guilty of wrongful trading if the person both:

- Knew or ought to have concluded prior to the commencement of proceedings that there was no reasonable prospect of the company avoiding an insolvent administration or insolvent liquidation
- Failed to take every step with a view to minimising the potential loss to the company's creditors as the director should have done

The standard is objective and subjective — that of a reasonably diligent director having both the general skill and experience that may reasonably be expected of a person carrying out the director's functions and the actual skill and experience of that director.

There is no reasonableness qualification on the steps to be taken and wrongful trading does not require any fraudulent or dishonest intent. However, liability only arises if, on a net basis, the company is worse off as a result of the continuation of trading.

Both administrators and liquidators can bring wrongful trading claims. Additionally, they can assign such claims to (amongst others) third parties, including to creditors or litigation funders.

The court may require a director liable for wrongful trading to make such contribution (an award) to the assets of the company as it thinks proper following an assessment of whether any loss was suffered as a result of the wrongful trading. In doing so the court will consider whether there has been an increase in the company's net deficiency over the relevant period (i.e., from the time when the directors first realised, or ought to have concluded, that there was no reasonable prospect of the company avoiding an insolvent administration or liquidation up to the time when the company entered into an insolvent administration or liquidation). If the court concludes an increase in net deficiency, it will also consider whether the director(s) have taken every step to minimise the potential loss to the company's creditors. Such award (if any) is compensatory in nature rather than punitive and the recovery will be contributed towards the

assets available for all creditors. A director held liable for wrongful trading may be subject to a disqualification order under the Company Directors Disqualification Act 1986. The minimum period of a disqualification order is two years and the maximum is 15 years.

COVID-19 adjustments

Although widely cited as a “suspension”, the changes introduced are more limited than the announcements indicated.

Limitation in scope

Firstly, a number of types of companies are excluded from the “suspension”, including insurance companies, banks, electronic money institutions, investment banks and firms, and payment institutions. A company is also excluded if it has permission to carry on a regulated activity under Part 4A of the Financial Services and Markets Act 2000 and is not required to refrain from holding money for clients. This limitation was not detailed at the time of the announcement.

Irrebuttable presumption?

Secondly, the change read literally is not a full suspension, but rather sets a presumption in favour of the director that he or she is not responsible for any worsening of the financial position of the company that occurs during the relevant period. Lord Callihan stated in the 9 June Commons debate that the presumption is irrebuttable. The explanatory notes to the new legislation state that the provision “sets out that the court will not hold a director responsible for any worsening of the financial position of the company or its creditors during the relevant period”. They also state that “[t]here is no requirement to show that the company’s worsening financial position was due to the COVID-19 pandemic”.

Relevant period

As indicated, the adjustment has been implemented to be retrospective to 1 March 2020. The normal position will resume, as things stand, on 1 October 2020. If the impact of the pandemic on businesses continues beyond 30 September 2020, the adjustment may be extended for up to six months using secondary legislation, and that process may be repeated, extending the suspension period further. If it becomes clear that the pandemic is no longer having an impact on businesses, the period of suspension may also be ended.

Winding up suspension

A temporary partial suspension of winding up petition is also in place until 30 September 2020 pursuant to the CIGA. For details and discussion, see Latham’s *Client Alert*.

To receive the latest COVID-19-related insights and analysis in your inbox, subscribe to Latham’s COVID-19 Resources mailing list.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Yen Sum
yen.sum@lw.com
+44.20.7710.1046
London

Simon Baskerville
simon.baskerville@lw.com
+44.20.7710.3033
London

Jennifer Brennan
jennifer.brennan@lw.com
+44.20.7710.1059
London

You Might Also Be Interested In

COVID-19: Resources for Responding to Business and Legal Issues

Relief for UK Companies: Court Protects Against Winding-up of Companies Due to COVID-19

What Rules Will Apply to Jurisdiction and the Enforcement of Judgments After Brexit?

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit https://www.sites.lwcommunicate.com/5/178/forms-english/subscribe.asp to subscribe to the firm's global client mailings program.