Latham & Watkins Restructuring & Special Situations Practice 29 March 2020 | Number 2674

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

Given the many fast-paced UK government announcements of COVID-19-related measures, this **Client Alert** ***provides a summary, as of 28 March 2020, of the proposed changes to UK insolvency laws.***

As of 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. This suspension is intended to ensure that directors in this uncertain COVID-19 environment are 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 for completeness. The authors will update this note as and when the legislation is published giving further clarity on the scope of such relaxation.

- Likely the same wrongful trading suspension legislation will include the implementation of plans to amend the insolvency regime and to introduce new insolvency restructuring regime procedures, which were previously announced in August 2018. The objective of the proposed changes is 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.

There is still very little detail on the new regime and its proposed implementation (although there has been extensive consultation and input from across the restructuring and insolvency community). However, a summary of the key features of the current insolvency regime against what was proposed in August 2018 is set out below. Moreover, the UK government's announcement of 28 March 2020 is also unclear about whether corporate governance changes — which were the subject of consultation initiated in March 2018 (due to a few high-profile corporate failures) — will also be incorporated as part of these anticipated emergency proposals. Given this uncertainty these potential measures are beyond the scope of this note.

The government announced that legislation to introduce these changes will be introduced in Parliament at the earliest opportunity. Provisions will be included to allow the changes to be extended if necessary.

These 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)
- 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 current 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.

Note that there is no reasonableness qualification on the steps to be taken and that 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.

The UK government has flagged on 28 March 2020 that these requirements will be temporarily suspended to account for the exceptional circumstances posed by the COVID-19 trading environment. However, the exact text of the moratorium and whether it goes further than this (*e.g.* as regards to the duty of directors of a company to act in the interests of its creditors when such company is in the "zone of insolvency") will become clear when the proposed bill is tabled in Parliament.

Insolvency Reform: Current vs Proposed Regime

Please note that there may be variations to some or all of these anticipated measures in the bill which is ultimately proposed.

	Current Regime	Proposed Regime
Moratorium	• No moratorium, except on filing for administration (and to a degree in compulsory liquidation and, upon application to the court, in voluntary liquidation) • Moratorium within company voluntary arrangement (CVA) process limited to specifically defined small companies	• Stand-alone moratorium supervised by monitor (qualified insolvency practitioner and officer of the court) for up to 28 days with a possible 28-day extension and further extensions — provided certain conditions are met (automatic if CVA or scheme has been proposed but its outcome not yet determined) • Open only to companies in a "state of prospective insolvency", based upon the requirement that a company will become insolvent if action is not taken; not open to certain categories of companies currently excluded from eligibility for small

		companies CVA moratorium, *e.g.* those involved in capital market arrangements • Intended to enable the company to reach an agreement with creditors; and monitor will be expected to assess whether, on the balance of probabilities, a rescue deal is more likely than not to be achieved • Debtor must be able to service debts “falling due” during the course of the moratorium • Creditors permitted to challenge moratorium by applying to the court at any time on grounds of qualifying conditions not being met or unfair prejudice to creditors • Repeal of existing small companies CVA moratorium
Contractual Termination	• Suppliers able to rely on insolvency termination clauses, with exceptions only for “essential” suppliers like water, gas, and IT services	• No reliance on *ipso facto* clauses, *i.e.* those clauses which permit a party to terminate a contract due to entry into formal insolvency procedure (*e.g.* administration, liquidation, or CVA) or on other grounds connected with the financial condition of the counterparty (including entry into moratorium or restructuring plan), with (as yet undefined) exclusions for certain types of financial products and services • Suppliers could still terminate on other grounds permitted by relevant contract, for example, for non-payment of liabilities incurred following entry into moratorium, restructuring plan, or formal insolvency procedure • Suppliers can apply to the court for relief on grounds of undue financial hardship; the court will weigh supplier’s detriment against impact on debtor’s prospects of rescue

Restructuring Plan	• Scheme of arrangement as Companies Act 2006 restructuring tool, with the following characteristics: − Can effect a compromise of a company's liabilities between a company and its creditors (or any class of creditors) − Jurisdiction threshold based on "sufficient connection"; open to companies regardless of solvency status − Voting majority of 75% by value and majority in number of those present and voting − Cram-down only per class of creditor − Court-sanctioned procedure • CVA as IA86 restructuring tool, but not effective vis-à-vis secured creditors	• Stand-alone restructuring plan open to all companies regardless of solvency status (except those excluded from new moratorium, *e.g.* those involved in capital market arrangements) • Process and class composition largely mirrored on schemes of arrangement but with added cross-class cram-down element for both secured and unsecured creditors and reliance on absolute priority rule with room for deviation with the court's sanction • New flexible valuation standard of "next best alternative" for creditors (*e.g.* administration (and a higher return) as opposed to minimum liquidation value) • Voting majority of 75% in value of gross debt of creditors within each class (who vote) and more than half of total value of unconnected creditors must vote in favour (like CVA, in which not more than half of total value of unconnected creditors must vote against)
Rescue Finance	• No statutory rescue finance provisions as under the US Bankruptcy Code, but market practice-led rescue finance provided for contractually	• As is — the government decided not to implement proposals to encourage rescue finance, but will keep under review
Prescribed Part	Under the current regime, realisations from floating charge assets are used to discharge amounts in the following order: • If the unsecured assets are insufficient:	• In addition to other anticipated changes, the Insolvency Act 1986 (Prescribed Part) (Amendment) Order 2020 provides that the "prescribed part" cap will increase to £800,000 on 6 April 2020 • Note that the increased cap will not apply if the company's net property is available to

	– First: Liquidation and administration expenses – Then: Preferential debts (both ordinary and secondary) (s. 175(2)(b) for liquidation and paragraph 65(2) of Schedule B1 for administrations) • In every case, unless disapplied, the "prescribed part" of the net property subject to the floating charge must be set aside for distribution to unsecured creditors (s. 176A IA86). This is calculated as 50% of the first £10,000 of the company's net property and 20% of anything thereafter, up to a maximum aggregate cap of £600,000. • Then: Amounts due to the floating charge holder	be distributed to the holder of a first-ranking floating charge created before 6 April 2020

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