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Coronavirus: Directors' duties under new UK insolvency laws

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In June, new legislation came into force in the UK which included a patchwork of temporary measures designed to give directors some certainty as they face extremely challenging economic headwinds. Amongst those changes was a temporary provision aimed at enshrining the idea that directors should not face personal liability for the unforeseeable consequences of a once in a century pandemic.

However, despite the changes, directors do still face significant sources of liability. We look at what has changed and – more importantly – what hasn't in terms of directors' liability, and what directors should do now.

What has changed?

If you are a director of a company facing financial uncertainty, in ordinary times one of your first concerns would be avoiding personal liability for 'wrongful trading'. Wrongful trading liability occurs where you know or ought to have known that your company cannot avoid entering insolvent administration or liquidation – that is, effectively, a company which cannot viably continue trading and rescue itself indefinitely without the intervention and protection of an insolvency process. In those circumstances, you must take every reasonable step with a view to minimising creditor losses. If you fail to do so, you can be liable to contribute to the company personally, to make good creditor losses.

Faced with this spectre of personal liability, you might opt for the safe haven of placing a distressed company into administration or some other formal insolvency process, under the supervision of a licensed insolvency practitioner. However, historically such processes have had a mixed track record of rescuing businesses. Entering into an insolvency process can itself be destructive of value in a business as it may trigger termination rights in key contracts.

With this in mind, and to avoid a wave of premature and economically damaging insolvency, the UK Business Secretary announced temporary changes to wrongful trading. For the period between 1 March 2020 and 30 September 2020, legislation provides that any court must assume that a director is not responsible for any worsening of the financial position of the company or its creditors. There is no requirement to show that the company's worsening financial position was due to the COVID-19 pandemic.

What has not changed?

While the changes to wrongful trading liability bring welcome certainty in one respect, they do not resolve the challenges facing directors entirely. It has long been the case that you, as a director, owe duties to creditors of insolvent companies. That remains the case and if you breach duties to creditors by failing to act properly and in their best interests, you will still be vulnerable to personal liability later.

Further, the UK Supreme Court is considering when the duties to shareholders 'kick in'. Directors of solvent companies owe duties to shareholders, and when those duties flip to considering creditors' interests as paramount is a vexed question. Under current law, the change happens when insolvency is 'likely' or 'probable'. The Supreme Court is considering an argument that the duty should change when there is a 'real risk' of insolvency – a much lower threshold.

Moreover, if a company is ultimately unable to avoid an eventual insolvency, an administrator or liquidator could have wide ranging powers to unwind past transactions entered into by the company, which preferred a particular creditor or which took place at undervalue. Your transactions are likely to be closely scrutinised and any within two years before the insolvency took place will be vulnerable to being unwound. Particularly for many SMEs, where directors are often the owners of the company and may have paid themselves significant dividends and/or salaries and bonuses during healthier economic times.

What should I do now?

The new legislation provides some relief until 30 September – not only because of the changes to wrongful trading but also because it has effectively put aggressive enforcement action by creditors on hold. In particular, the legislation provides that statutory demands issued before 30 September are void and no winding up proceedings can be pursued unless it can be shown that the company's solvency difficulties are unrelated to the Covid-19 pandemic (a tall order in most cases, where the multi-faceted effects of the pandemic will be difficult to disentangle from any pre-existing difficulties).

You should use this time wisely to plan for challenging economic times in the medium term, when less support from the Government is likely be available. Proactively considering what changes may need to happen to allow your business to operate, including any significant restructuring and refinancing needs, will be beneficial for the future of your business.

Permanent changes to the UK insolvency framework have also introduced a range of new options which can help companies to restructure while avoiding a value destructive insolvency process. Notably, the UK has introduced a debtor in possession process, which will allow you to keep running the company day to day, while benefitting from a short term 'moratorium' that will prevent enforcement action by creditors or the termination of supply contracts. This type of process has seen considerable success in other jurisdictions in promoting a rescue culture and ending the perception that seeking insolvency protection could be terminal, even for companies.

If you need advice in relation to your liabilities as a director or if you are seeking to restructure a business, please do get in touch.

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