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BRIEFING PAPER

Number 8877, 31 March 2020

Coronavirus: changes to insolvency rules to help businesses

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Summary

On Saturday 28 March 2020, the Business Secretary, Alok Sharma, announced new insolvency measures to help businesses hit by the coronavirus crisis. Legislation is to be introduced in Parliament at the earliest opportunity. Significantly, there is to be a three-month suspension of the wrongful trading rules in order to remove the threat of directors incurring personal liability whilst trading during the pandemic. The change in law is to be applied retrospectively from **1 March 2020** for an initial period of three months. However, all other "checks and balances" that help to ensure directors fulfil their legal duties properly will remain in force.

Other new insolvency measures include allowing companies to continue to access essential supplies (such as raw materials, component parts, energy etc) while attempting to rescue the business. Companies undergoing a restructuring process will also be given a time limited moratorium or breathing space from creditor action. The aim is for directors to keep their businesses trading during the pandemic, paying their staff and suppliers, even if there are insolvency fears, without the threat of incurring personal liability. Speaking at a Downing Street press conference, Alok Sharma said he hoped the measures would give firms "greater flexibility" and the extra time and space they need to "weather the storm" and "emerge intact the other side" of the pandemic.[1]

This briefing paper considers the new insolvency measures and why they are considered necessary to help companies survive the pandemic. It will be updated with more detailed information once the proposed legislation has been published. This is a fast-changing situation and it is anticipated that the new measures announced, and the corporate insolvency framework, will continue to evolve in the coming weeks.

[1] Department for Business, Energy & Industrial Strategy, HM Revenue & Custom, The Insolvency Service, Health and Safety Executive, Office for Product Safety and Standards, and the Rt Hon Alok Sharma MP, Press Release, "Regulations temporarily suspended to fast-track supplies of PPE to NHS staff and protect companies hit by COVID-19", 28 March 2020

1. Introduction

Due to the global outbreak of COVID-19, many UK businesses are confronting serious commercial consequences, including a fall in consumer demand, delays in delivery of essential supplies, and cashflow difficulties. Some businesses (e.g. retail and hospitality) have been forced to stop trading altogether because of the nationwide lockdown.

Reportedly, the government has been in discussion with various stakeholders about urgent changes to insolvency laws in order to save viable businesses.[2] On 28 March 2020, the Business Secretary, Alok Sharma, announced that the government would make changes to enable companies in financial difficulty to continue trading, allowing them to access essential supplies, whilst undergoing a rescue or restructure process. At the same time, companies would be given a short moratorium from creditor action, a "breathing space", in which to restructure and attempt to avoid insolvency. In addition, wrongful trading rules would be suspended for three months with retrospective effect from 1 March 2020. Announcing these new measures, Alok Sharma explained the government's position as follows:

> The government is doing everything in its power to save lives and protect livelihoods during these unprecedented times.
>
> Applying a common-sense approach to regulation will ensure products are safe and reach the market without any unnecessary delay, getting vital protective equipment such as face masks to frontline staff as quickly as possible.
>
> Today's measures will also reduce the burden on business, giving bosses much-needed breathing space to keep their workers employed and their companies going.[3]

By way of comparison, the German and Australian governments have already introduced laws to make it harder for creditors to companies to file winding-up petitions during the coronavirus crisis.

The UK's new insolvency measures should be seen in the context of other financial support that the Chancellor, Rishi Sunak, has already introduced, including allowing companies to defer VAT payments and stop paying taxes on property leases. There has also been a moratorium on commercial property evictions for businesses that miss rent payments.

On the same day as the government announced the insolvency reforms, it also announced new company law measures. Specifically, companies will temporarily be extended greater flexibilities, including holding AGMs online or postponing the meetings. This measure follows an

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2 See for example: "Changing the Narrative around Administration", Insolvency Lawyers' Association, 26 March 2020 and "CLLS Insolvency Law Committee Paper – mitigating the effects of COVID-19", The City of London Law Society, 26 March 2020, (accessed 31 March 2020) [both online]

3 Department for Business, Energy & Industrial Strategy, HM Revenue & Custom, The Insolvency Service, Health and Safety Executive, Office for Product Safety and Standards, and the Rt Hon Alok Sharma MP, Press Release, "Regulations temporarily suspended to fast-track supplies of PPE to NHS staff and protect companies hit by COVID-19", 28 March 2020

earlier announcement that companies would automatically and immediately be granted a three-month extension to the filing of their accounts following a fast-track online process. According to BEIS, over 10,000 businesses have already successfully applied for the extension.[4]

[4] Ibid

2. Existing insolvency rules

Company liquidation and administration are complex legal procedures and the proposed new insolvency measures are technical in nature. To understand the measures and to put them into context, this section of the paper summarises the current legal position.

2.1 Directors' duties to suppliers and creditor action

As a result of the national lockdown many companies have suddenly found themselves in a position where they are unable to pay their suppliers. Effectively, they are insolvent on a cash flow basis. This has brought the issue of directors' obligations to their suppliers, and the action that can be taken by unpaid suppliers, into sharp focus.

Directors are under a statutory duty to exercise reasonable care and skill in the management of the company. When a company is solvent, its directors are under a duty to act in the best interests of the company and its shareholders. When insolvent, directors have a duty to act primarily in the interests of the company's creditors. This obligation on directors to consider the interests of creditors also applies to shadow and "de facto" directors.

A widely used enforcement option used by an unpaid supplier is to issue a winding up petition against the debtor company (assuming the supplier is owed at least £750 which is overdue for payment and where the debtor company has no legal right to refuse payment). Currently, owing to COVID-19, winding-up petitions scheduled for hearing, are now being largely adjourned to hearing dates in June onwards. There is in effect a form of de facto moratorium for winding-up petitions.

Nevertheless, the issue of a winding up petition will still have a serious adverse impact on the debtor company and may bring about its collapse.

2.2 Wrongful trading rules

It is the director's responsibility to know whether the company is trading while insolvent. They must consider not only the company's balance sheet (and balance sheet solvency) but also the company's ability (actual and expected) to pay its debts as and when they fall due. Under section 214 of the Insolvency Act 1986, directors can be held personally and legally responsible for continuing to trade while insolvent. This is known as the offence of wrongful trading (see **Box 1**).

A viable company in financial difficulties may be able to trade through its difficulties (or a period of ongoing trading may result in a better outcome for creditors) than an immediate cessation of trade. However, in many cases, it is directors' potential exposure to personal liability which influences the decision to put the company into liquidation or administration.

Box 1: Wrongful trading

There are circumstances in which directors of an insolvent limited liability company can be held personally liable for the company's debts. Section 214(2)(b) of the Insolvency Act 986 outlines the offence of wrongful trading. A director may be liable to contribute personally to the assets of the insolvent company for the benefit of its creditors if:

> ..at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

In effect, wrongful trading occurs when the director knew or ought to have concluded before the company became insolvent that there was no reasonable prospect of avoiding insolvency yet continued to trade. Action under this section would be taken by the liquidator in conjunction with specific orders from the court.

Wrongful trading is a statutory offence under section 214 and section 246ZB of the Insolvency Act 1986. If, after the company has gone into insolvent administration or liquidation, it appears to the court that a director has failed to comply with this duty, the court can order the director to make such contribution to the company's assets as it thinks appropriate.

It should be noted that the Small Business, Enterprise and Employment Act 2015 (Section 246ZB) extends the powers to take action against directors for wrongful trading (which previously were only available to a liquidator) to an administrator.

Only directors can be liable for wrongful trading (unlike fraudulent trading). "Director" is widely defined by the Insolvency Act 1986 to include any person occupying the position of director, by whatever name called. This means that a "de facto" director or a shadow director may be liable for wrongful trading. The person must be a director of the company at the time he knew (or should have known) that there was no reasonable prospect of the company avoiding insolvent liquidation or insolvent administration. In other words, a director who resigns from office may still be liable for any wrongful trading that took place during his/her time in office.

Dishonesty is not required; in other words, there is a lower burden of proof for wrongful trading than that required to prove fraudulent trading. It is a civil, not criminal, offence. Crucially, a person held liable for wrongful trading may also be the subject of a disqualification order under the Company Directors Disqualification Act 1986.

However, there is a statutory defence. A court will not make an order for wrongful trading if, knowing there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration, the director took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken (sections 214(3) and 246ZB(3) of the Insolvency Act 1986).

Further detailed information is provided in a separate Library briefing paper, "Company insolvency: potential liabilities of directors" (CBP 7936).

3. Consultation: changes to corporate insolvency regime

The government previously consulted on changes to the corporate insolvency regime and in August 2018 announced plans to introduce new restructuring procedures. Based on Alok Sharma's announcement on 28 March 2020, it now appears that the government intends to fast track the implementation of these proposed reforms (as well as suspend the law on wrongful trading) in order to help viable companies to survive the crisis created by COVID -19.

By way of background information, on 26 August 2018, the government published its response[5] to the March 2018 consultation on "Insolvency and Corporate Governance" and the earlier May 2016 review of the "Corporate Insolvency Framework". In this response, it announced plans to introduce new insolvency restructuring procedures designed to help businesses to continue trading through the rescue process. The proposed reforms included:

- the introduction of a short moratorium for companies in financial distress (preventing creditor action, including the issue of winding up petitions) to help facilitate business rescue;
- the protection of essential supplies during the moratorium period, to enable companies to continue trading whilst they formulate a rescue plan; and
- action to improve the insolvency framework in cases of major failure.

According to the government, the proposed reforms would strike a fair balance between the rights of the company seeking rescue and the rights of creditors seeking payment of debts. Of course, at the time, the government did not have in mind the unprecedented commercial difficulties imposed by COVID-19.

Further detailed information is provided in a separate Library briefing paper, "Corporate insolvency framework: proposed major reforms" (CBP 8291).

5 Department for Business, Energy & Industrial Strategy, "Insolvency and Corporate Governance – Government Response", 26 August 2018, [online] (accessed 29 March 2020).

4. New insolvency measures

There is little technical detail on the new insolvency measures beyond what the Business Minister said during his announcement on 28 March 2020. The proposed changes are:

- temporary suspension of **wrongful trading** provisions – to be applied retrospectively from **1 March 2020** for an initial period of three months – to allow directors to continue trading through the pandemic emergency without the threat of personal liability should the company ultimately fall into insolvency;
- a short **moratorium** for companies giving them a breathing space from creditor action, whilst they seek rescue or restructure;
- allowing companies **continued access to their supplies** (such as raw materials, component parts etc.) so they can continue to trade during the moratorium; and
- a **new restructuring plan** (including a "cross-class cram-down"), binding creditors to that plan including key safeguards for creditors and suppliers to ensure they are paid while a solution is sought.

The government hopes these measures will give directors greater confidence to use their best endeavours to continue to trade during the crisis, without the threat of personal liability should the company ultimately fall into insolvency. In effect, directors can keep their businesses trading, continue to buy essential supplies and employ staff, without the threat of personal liability.

Various commentators have suggested that the proposed relaxation of the wrongful trading rules should be treated with caution by directors, and that they should remain vigilant about their conduct, particularly as other legal risks continue to exist.[6] Similarly, the threat of director disqualification continues as a deterrent against director misconduct.

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6 For example: **fraudulent trading** (which can impose criminal as well as civil liability on directors); **misfeasance** (i.e. wrongdoing or misapplication of funds by directors); and the law on "**antecedent transactions**" (i.e. transactions at an undervalue and preference whilst a company is insolvent)

5. Views of stakeholders

Prior to Alok Sharma's announcement on 28 March 2020, and in the context of COVID-19, there had been calls on the government to act quickly to amend wrongful trading laws to help prevent corporate failures. For instance, Jonathan Geldart, director-general of the Institute of Directors, said:

> We're calling on the government to prioritise jobs and business survival by relaxing existing insolvency obligations put on directors and thereby providing business leaders greater room for manoeuvre at this critical juncture.
>
> We should not allow a single viable business to go to the wall because of this crisis.[7]

The Confederation of British Industry (CBI), welcomed the government's announcement to introduce new insolvency measures to help save businesses:

> The temporary suspension of wrongful trading provisions, along with other measures, will give much needed headroom for company directors to enable otherwise viable businesses to use the government's support package and weather this crisis.[8]

Jennifer Marshall, president of the Insolvency Lawyers Association also welcomed the new measures:

> We welcome and support these proposals. Suspending wrongful trading, in particular, will assist directors in accessing Government or bank funding without concerns regarding personal liability.
>
> The insolvency profession in the UK is hugely talented and these reforms, together with existing rescue tools such as administration, could really assist in saving livelihoods.[9]

Others, including PwC, argued that changes to the wrongful trading rules should help alleviate much of the anxiety directors are facing in relation to ongoing trading decisions.[10] Suren Thiru, head of economics at the British Chambers of Commerce (BCC) thought it "sensible" for the government to protect viable companies weakened by the pandemic. He said:

> It is right that the rules on wrongful trading are temporarily suspended to ensure that directors are not penalised for doing all they can to save companies and jobs during this turbulent period. Companies that were viable before the outbreak must be supported to ensure they can help power the recovery when the immediate crisis is over. Cashflow remains an urgent concern for

7 "UK eyes insolvency law reforms", Financial Times, 25 March 2020 [online] (accessed 25 March 2020)

8 Ibid

9 Department for Business, Energy & Industrial Strategy, HM Revenue & Custom, The Insolvency Service, Health and Safety Executive, Office for Product Safety and Standards, and the Rt Hon Alok Sharma MP, Press Release, "Regulations temporarily suspended to fast-track supplies of PPE to NHS staff and protect companies hit by COVID-19", 28 March 2020

10 "Industry responds to wrongful trading suspension", TRI press release, 30 March 2020 [online] (accessed 30 March 2020

> many businesses, so its vital that government support packages reach businesses and people on the ground as soon as possible.[11]

However, some stakeholders, including the insolvency and restructuring trade body R3, have expressed concern about the government's plans. Duncan Swift, President of R3 said:

> The profession will have some serious concerns about the government's plans to suspend wrongful trading. A blanket ban could risk abuse. The provisions are there for a reason and protect creditors.[12]

The Institute of Chartered Accountants in England and Wales (ICAEW) has cautioned directors of companies in financial difficulty to seek professional advice:

> This is a pragmatic move and a useful addition to the government's strategy to protect employment and will definitely help some businesses to survive. But we would encourage any directors with concerns about their company to seek professional advice at the earliest opportunity.[13]

11 British Chambers of Commerce press release, "BCC responds to changes to insolvency laws", 28 March 2020, [online] (accessed 29 March 2020).
12 Ibid
13 Ibid

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