



## Thomas More Chambers

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### **Wrongful Trading & COVID-19: FAQs**

#### ***Who should read this FAQs?***

This article is aimed at the directors, owners and managers of small businesses and their advisors. It is of particular importance to businesses which find themselves in financial distress as a result of the COVID-19 pandemic as well as businesses which provide credit to companies which may now be in financial distress.

#### ***What is wrongful trading?***

In general terms, wrongful trading occurs when the director of a limited company fails to minimise the potential losses to a company's creditors at a time when he or she knew, or should have known, that there was no reasonable prospect that that company would avoid insolvency.

The effect of this is that once insolvency appears to be inevitable, the director's duties shift from maximising profits for the company's shareholders to minimising the losses of the creditors: a reversal from normal business practices.

It is worth noting that wrongful trading does not require the director to intend to defraud any creditor by his or her actions, although if it can be shown that that was the intention, then the director may be guilty of fraudulent trading which is a criminal offence.

The specific requirements for all these provisions are somewhat complex and are set out in s.214, Insolvency Act 1989 and the accompanying case law. Please contact Thomas More Chambers if you would like specialised advice as to the application of them to your situation. Finally, it is important to note that the prohibitions on wrongful trading do not directly apply to those who run their businesses as sole traders—whether trading under their personal



names or a business name—or unincorporated partnerships / firms where two or more people work together under the same name.

### ***What are the consequences of wrongful trading?***

The court has two powers: firstly, it may make an order that the director makes a contribution to the debts of the company which are then paid to the creditors. This is one of the main exceptions to the usual rule that a limited company protects its directors from personal liability.

Secondly, the court may make an order disqualifying the director from serving as a company director for up to 15 years. This is designed to act as a sanction and a protection against other companies in future.

The same powers apply to fraudulent trading, with the scope for additional criminal penalties following successful prosecution in the criminal courts.

### ***What is the government proposing to do about wrongful trading during the pandemic?***

The government announced that, on 28<sup>th</sup> March 2020, it would be:

*“temporarily suspending wrongful trading provisions retrospectively from 1 March 2020 for three months for company directors so they can keep their businesses going without the threat of personal liability”.*<sup>1</sup>

At the time of writing (17<sup>th</sup> April 2020) there is little more information than this available. Laws implementing this suspension were not included in the Coronavirus Act 2020, The Health Protection (Coronavirus, Restrictions) (England) Regulations 2020 (the “lockdown” regulations), nor any of the other statutory instruments relating to the pandemic.

It is very likely that primary legislation will be required to implement this suspension, due to it being an economic measure which has retrospective effect on the private rights of creditors, and so may be included in the next coronavirus act which it is anticipated will be brought through Parliament as soon as it has returned from its Easter recess.

<sup>1</sup> <https://www.gov.uk/government/news/regulations-temporarily-suspended-to-fast-track-supplies-of-ppe-to-nhs-staff-and-protect-companies-hit-by-covid-19>.



### ***What is likely to be the effect of the suspension?***

There are likely to be two categories of companies which are affected by the suspension: those which are pushed into insolvency due to the pandemic and those which would be insolvent in “normal” times.

It is difficult to say the suspension will have a large effect on businesses which would be solvent, were it not for the pandemic, beyond providing general reassurance for company directors. The reason for this is that the very extensive package of financial and other support implemented by the government may have made it hard for an applicant to show that a director ought to have concluded that there was no reasonable prospect of a company avoiding going into liquidation.

In particular, by far the majority of winding up petitions are brought due to the non-payment of taxes. The combination of the furlough scheme—where the grants not only pay the 80% of the employee’s net wages but also cover PAYE and NIC—and the government’s decision to permit VAT payments due between 30<sup>th</sup> March and 30<sup>th</sup> June 2020 to be deferred until 31<sup>st</sup> March 2021<sup>2</sup> may have given any director considerable scope for arguing that there was a reasonable prospect of keeping the company solvent. Indeed, this position may strengthen if the government also brings in a proposed “breathing space” moratorium of between 28 and 90 days on the enforcement of company debts.

The bigger effect, however, is likely to be on businesses which would have become insolvent despite the pandemic. For directors of these companies, the suspension will provide a unique protection. As long as they do not intend to defraud any creditors, there may be no practical sanction or consequence for increasing the company’s debts even though it was clear that the business had no reasonable prospects of surviving.

As a result, those who are most affected by the suspension are likely to be companies who provide credit to other businesses, particularly those companies which supply goods or services on terms which do not require payment up-front. These businesses cannot now

<sup>2</sup> <https://www.gov.uk/guidance/deferral-of-vat-payments-due-to-coronavirus-covid-19>.



assume that the directors of the limited companies with which they are trading will refocus their attentions from shareholders to creditors at the point their company is approaching insolvency. There will also be no sanction for personal liability if they do not.

In the longer term, it may be that there will be an up-turn in applications for other civil remedies against directors, either under the general duties of acting in good faith<sup>3</sup> or due to fraudulent trading, although how successful these course will be is hard to predict.

***Are there any steps which companies offering credit should take for their protection?***

Whilst no firm advice can be offered in the absence of consideration of a business' individual circumstances, companies regularly providing credit might wish to consider seeking personal guarantees from the directors of any company to which they provides credit, setting out that they will be liable any debts accrued by the company in circumstances where they would be liable for a contribution for wrongful trading were the suspension not passed. This may provide a measure of protection in a manner which is palatable to most conscientious directors.

***Are there any concerns about the proposals?***

There are some surprising features of the suspension which make it considerably more generous to directors than one might expect:

1. It appears to affect both private debts between two companies as well as public debts between a company and the state. By including the former, it favours businesses which generally obtain credit rather than supplying it. It is hard to justify this over the whole economy where, for example, many small businesses, who have to pay for their supplies up-front, will then supply goods on credit to larger ones.
2. The start-date of the suspension—1<sup>st</sup> March 2020—predates both the “lockdown” and the informal closures of businesses by the pandemic. It is hard to understand the justification for the protection of directors in this early stage.

<sup>3</sup> See s.172 Companies Act 2006.



3. The exception to wrongful trading does not simply apply to businesses which are affected by the pandemic. Since many thousands of winding up petitions are presented to the court each year by creditors owed money by insolvent companies, it is difficult to understand the protection for directors over businesses that would have otherwise inevitably failed.

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**JACOB GIFFORD-HEAD  
THOMAS MORE CHAMBERS**

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*The Thomas More Chambers Insolvency Law Team is able to assist instructing sources on any insolvency law issues arising from the Coronavirus crisis. If you need such assistance, please contact Craig Brown, Senior Civil Clerk on 020 7404 7000 or at [cbrown@thomasmore.co.uk](mailto:cbrown@thomasmore.co.uk).*

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