UK Government Announcement Regarding Changes to the UK’s Insolvency Regime Prompted by COVID-19

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Introduction
On 28 March 2020 the UK government (the “Government”), following the lead of Australia and Germany, announced plans to introduce a temporary relaxation of the existing wrongful trading regime for company directors. Specifically, the Government has communicated its intention to introduce new legislation at the “earliest opportunity” to suspend wrongful trading laws for a period of 3 months (with the ability to extend this period if deemed necessary), to allow directors to continue to pay staff and suppliers without risk of personal liability should their business later become insolvent. In the same announcement, the Government indicated further-reaching insolvency law reforms. In this QuickStudy, the authors consider the implications of that announcement.

Current law on wrongful trading
The law on wrongful trading is contained in section 214 and section 246ZB of the Insolvency Act 1986. Once a director or directors of a company conclude (or should have concluded) that there is no reasonable prospect of the company avoiding an insolvent liquidation or, in relation to business conducted on or after 1 October 2015, insolvent administration, they have a duty to take every step which a reasonably diligent person would take to minimise potential loss to the company’s creditors. 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 proper.

Covid-19 and Government proposals
In the current climate where, for example, directors will be grappling with issues such as incurring further credit with a company’s supply chain and/or the continued payment of staff (and associated PAYE/NIC liabilities to HMRC), directors will welcome the certainty of the Government’s announcement that personal liability for wrongful trading will be temporarily suspended. We understand that this extraordinary suspension will apply retroactively from 1 March 2020 for an initial period of three months but with flexibility to extend that period if needed.

The authors welcome, too, the Government’s statement, but in the absence of specific detail in the Government’s proposals note that:

- Successful ‘wrongful trading’ claims are, in the authors’ experience, relatively rare in any event since the underlying legislation contains a mechanism to protect directors in special circumstances provided that they “do the right thing” and take appropriate steps to mitigate losses to creditors. Determination of wrongful trading requires the satisfaction of an objective test around the director’s functions and a subjective test concerning the general knowledge, skill and experience of that director. The authors query whether current purposes might have been better served by clearer guidance on the underlying legislation and its implications for directors.
- Directors will also need to be mindful that the Government’s proposals only extend to ‘wrongful trading’. In its statement, the Government highlighted that “all of the other checks and balances that help to ensure directors fulfil their duties properly will remain in force”, by which the authors understand that laws in respect of inter alia ‘fraudulent trading’ and ‘misfeasance’ remain in place together with the threat of director disqualification.
- The reforms will be introduced in Parliament “at the earliest opportunity”. In practice, this will depend on whether Parliament is able to return from recess on 21 April. It is unclear how these changes would be implemented in the event of an extended recess.
• On the possible negative side, the suspension of the wrongful trading rules could be open to abuse by those at the helm of companies racking up debts that they have no hope or even intention of paying. The devil of the new legislation will be in the detail. There will doubtless be a call in some quarters to revert to the existing regime the moment the Covid-19 crisis is behind us.

UK insolvency law reform
In addition and, in the authors’ view, with longer-lasting and more profound implications, the Covid-19 crisis has precipitated a fresh engagement by Government with the plans of the previous government to reform UK insolvency law. These plans were developed in the publication in August 2018 of that government’s response to its consultation on potential reforms to insolvency law. Of the 2018 proposals, the Government’s announcement specifically references three:

• a new restructuring moratorium for viable companies undergoing a restructuring process to allow them time to negotiate an out-of-court restructuring;
• preservation of a company’s ability to continue to access essential supplies such as energy, raw materials or broadband while it undergoes a restructuring; and
• a restructuring “plan” which will bind all creditors.

The authors remain optimistic that, if implemented, these proposals will represent a considerable reform to UK insolvency law not seen since 2002. For the first time, assuming implementation in line with government consultation, a restructuring plan will be capable of implementation without the consent of each class of creditor through a cross-class cram-down mechanism subject to a modified version of the US Chapter 11 absolute priority rule.

Again, however, the authors sound a note of caution since the Government has yet to provide specific details of how these changes will be implemented. For example, in granting a company ‘breathing space’ there are no further details at this stage on whether the measures will result in some form of restriction on hostile creditor action. Similarly, in relation to access to essential supplies it is unclear how legislation will manage the tension between allowing a degree of forbearance for companies in difficulty without simply allowing bad debtors more time to pass their liquidity difficulties on to suppliers, thereby pushing Covid-19 issues down the supply chain.

Summary and next steps
In summary, the current circumstances faced by businesses are unique in living memory and efforts by the Government to support businesses through the provision of additional liquidity measures (see Locke Lord’s recent QuickStudy: UK Government Announces Support for Business Affected by COVID-19) or a reshaping of the insolvency and reshaping landscape are to be welcomed. The authors will follow with interest as the legislative framework for these provisions takes shape.

Locke Lord’s London team has considerable experience advising on a host of insolvency/restructuring and funding matters across all sectors in the UK and globally. For more information on the matters discussed in this Locke Lord QuickStudy, please contact the authors.

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