Wrongful Trading – claims now available in liquidation <u>and</u> administration

Directors of a company are subject to certain duties under the Companies Act 2006. These duties are of obvious importance throughout their service as a director but some of them become particularly important during the period leading up to the insolvency of the company. If a current or former director of a company knew or ought to have concluded at a point before the commencement of administration or insolvent liquidation that there was no reasonable prospect that the company would avoid going into such a process, the director can be liable for wrongful trading under sections 214 and/or 246ZB of the Insolvency Act 1986. If the director is liable for wrongful trading, he/she can be personally liable to make such contribution to the Company's assets as the Court thinks fit, unless the Court is satisfied that the director took every step with a view to minimising the potential loss to the Company's creditors.

The components and possible defence to a wrongful trading claim were recently considered and clarified in the case of *Ralls Builders Limited (in liquidation) [2016] EWHC 243 (Ch).*

<u>Ralls Builders Limited (in liquidation) [2016] EWHC 243 (Ch).</u>

Ralls Builders Limited ("the Company") was a framework contractor for local authorities and other public sector clients. In the year to 31 October 2009, the Company began to make trading losses after suffering from disruption during the winter months and incurring substantial liabilities to the council as a result of defective works performed by a sub-contractor. The Company ultimately entered administration on 13 October 2010 before being moved into liquidation in January 2011.

The liquidators of the Company applied to court for a declaration against the directors of the Company pursuant to section 214(1) IA 1986 seeking a contribution to losses caused to the Company and to the costs and expenses of its administration and subsequent liquidation. They argued that on or about 31 July 2010 or alternatively, at least by 31 August 2010, the Directors knew or ought to have concluded that there was no reasonable prospect that the Company would avoid going into insolvent liquidation. This was because by the time the draft audited accounts for the financial year to 31 October 2009 were produced in June 2010, it was apparent that the Company was heavily balance sheet insolvent and was also suffering severe pressure from trade creditors and HMRC. The Liquidators argued that despite this, the directors continued to trade the business of the Company.

The Directors denied that at any time before the decision to put the Company into administration in late September 2010, they knew or ought to have known that there was no reasonable prospect of avoiding an insolvent liquidation. They contended that from the end of July 2010 they were taking steps which had a reasonable prospect of rescuing the Company and avoiding an insolvent liquidation. In particular, they were trying to persuade a third party, Mr James, to acquire a percentage of the Company's parent company, the proceeds of which would have been applied towards payment of creditors. Further, the Directors took the view that continued trading throughout the summer months would be profitable and maximise recoveries from customers, thereby improving, not worsening, the position of creditors.

Mr Justice Snowden refused to make a declaration under section 214(1) IA 1986, finding the Directors were not liable for wrongful trading. In giving his judgment, he clarified the following points:

Quantum of claims – how the 'increase in the net deficiency' should be calculated

The judge agreed with the Directors' contention that the correct approach to whether the Directors should contribute under section 214(1) IA 1986 is to ascertain whether the Company's creditors suffered loss which was caused by the continued trading by the Company after 31 August 2010. As a starting point, the question is whether there was an increase or reduction in the net deficiency of the Company as regards unsecured creditors between these two key dates. This in turn would show a necessary causal connection between the amount of any contribution and the continuation of trading.

In this instance, the continuation of trading by the Directors after 31 August 2010 did not cause any, or any material, increase in the net deficiency of the Company. Indeed, the figures suggested that the continued trading by the Company until 13 October 2010 produced a modest improvement in the Company's net deficiency.

Considerations for directors trading in the twilight period whilst awaiting investment

The judge reiterated that the mere fact a company is insolvent (on a balance sheet or cash-flow basis) and carries on trading does not mean a director, even one with knowledge of the company being insolvent – will be automatically liable for wrongful trading if the company fails to survive **(BNY Corporate Trustee Services Limited v Eurosail-UK2007-3BL PLC [2013] 1 WLR 1408** and **Hawkes Hill Publishing Co. Limited [2007] BCC 937).**

Further, the judge commented that the test for determining whether a director knew or ought to have known that there was no real prospect of the company avoiding insolvent liquidation or administration is not determined by a snapshot of the company's financial position at any given time; it depends on rational expectations of what the future might hold **(re Kudos Business Systems [2011] EWHC 1436).**

The decision of the Directors in this case to continue trading (on the basis of potential profits to be made in the summer months and securing certain contracts) was justifiable and likely to have produced a significantly better result for the Company. The judge sympathised with the Directors' view held at the relevant time, that a complete cessation of trading would not have been in creditors' interests. However, the judge found that whilst the reliance on the possible capital injection of Mr James was also initially justifiable, by the end of August 2010 there was no longer any reasonable prospect of Mr James making the investment and this should have led the Directors to conclude at that stage there was no reasonable prospect of the Company avoiding an insolvent liquidation. However, this alone was not sufficient to warrant the Directors being required to make a contribution to the assets of the Company.

The importance of advice from insolvency professionals

Professional advice is a key factor in assessing what conclusions a director ought to have drawn on the prospects for his company **(Hawkes Hill** and **Continental Co of London plc (No.2); [1988] 1 BCLC 583).** On 2 August 2010, the Company's financial adviser, Mr Tickell of Portland Business & Financial Solutions Limited, was told about Mr James' interest and was made aware of the Company's financial situation. In his letter to the Directors dated 6 August 2010, despite raising some brief concerns, Mr Tickell did not suggest that it was implausible to pursue the investment from Mr James, nor did he suggest that the Directors pursue a different course of action. The judge concluded that the Directors were not given any indication by Mr Tickell that they were trading wrongfully or that the Company was doomed to failure and therefore would not have been aware if this had been the case.

The issue of replacing old creditors with new creditors – when the overall financial position does not deteriorate

When section 214(1) IA 1986 is triggered, the court should consider the availability of a defence under 214(3) as it contains a limitation on the circumstances in which the court can make a declaration under section 214(1). To invoke this defence, it must be shown that the director took "every step with a view to minimising the potential loss to the company's creditors as he ought to have taken".

The judge held that this defence was not made out, despite the fact the Directors succeeded in reducing the net deficiency of the Company as regards its general body of unsecured creditors. This is because the Directors chose to continue trading in a way that meant that the Bank and some of the existing unsecured creditors were paid at the expense of new creditors, who ended up not being paid. The judge said that the nature of the wording adopted in Section 214(3) ("every step") meant that it was intended to be a high hurdle for directors to overcome. The Directors relying on section 214(3) must show not only that continued trading was intended to reduce the net deficiency to creditors but also to minimise the risk to individual creditors. They had failed to do this.

This case provides very helpful clarification to insolvency practitioners, directors of companies and their advisers. Even though a company may seem as though it is doomed to failure on a balance sheet or cash-flow basis, if the directors seek advice from professionals and act reasonably in a way that is designed to be in the best interests of the company's creditors, it may absolve them from liability for wrongful trading. If not, then in order to obtain the benefit of any limitation to that contribution, they will have to overcome a high threshold by showing that they took "every step" to minimise loss to the company's creditors, including new creditors.