One of the key tools for holding such directors to account is the wrongful trading regime. Unsurprisingly, steps were taken, as part of the initiative to clamp down on ‘dodgy directors’, to make it easier to initiate wrongful trading claims against such directors. However, two years on, a mixture of policy decisions and judgments, including the recent decision in *Re Ralls Builders Ltd* [2016] EWHC 243 (Ch), have made it less likely that a company’s creditors will benefit from such claims. This alert examines why this is the case, focusing on the challenges involved in bringing a successful wrongful trading claim.

### What is ‘wrongful trading’?

Directors of English companies must comply with a range of statutory, common law and fiduciary duties, including a duty, where a company is facing financial difficulties, to have regard to the interests of creditors. This requirement is reinforced by the ‘wrongful trading’ provisions contained in Section 214 of the Insolvency Act 1986, which give the court a discretionary jurisdiction to declare that a director of a company in insolvent liquidation or administration may be ‘liable to make such contribution (if any) to the company’s assets as the court thinks proper’. Such a declaration may be made if:

- the court is satisfied that the director knew (or should have known) that, at some time before insolvency proceedings began, the company had no reasonable prospect of avoiding going into insolvent liquidation or administration; and

- once it had become clear to that director that there was no longer a reasonable prospect of avoiding insolvent liquidation or administration, he or she did not take every step to minimise the potential loss to creditors that they should have taken.

### Recent statutory attempts to make it easier to bring wrongful trading claims

It would be wrong to judge the success of wrongful trading legislation purely by the number of claims brought since its inception, as there is no way of knowing how many directors have been influenced, when taking decisions, by the threat of being found liable for wrongful trading. The statistics would, however, appear damning, as Government figures suggest that, between 1986 and 2013, there were only 29 reported cases of wrongful trading and that personal liability was imposed on directors in just 11 of those cases.

In April 2014 Vince Cable, the then Business Secretary, issued a press release headed ‘Cable takes aim at dodgy directors’ in which he was quoted as saying that ‘rogue directors can cause a huge amount of harm in terms of large financial losses, unnecessary redundancies and lifelong investments going down the drain. It is only right that we should put the toughest possible sanctions in place, make sure we stamp out unfair practices and deter those who are looking to act dishonestly.’
In an attempt to improve this position, the Small Business, Enterprise and Employment Act 2015 (SBEE) introduced the following changes in order to make it easier to pursue wrongful trading claims:

> **Wrongful trading claims extended to administrators:** Administrators, as well as liquidators, are now permitted to bring fraudulent and wrongful trading claims; removing the need to wait until the company goes into liquidation before an action can be commenced;
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> **Requirement for sanction abolished:** Liquidators no longer need to seek approval before bringing a wrongful trading claim; and
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> **Assignment of wrongful trading claims:** Most significantly, liquidators and administrators are now allowed to assign their officeholder causes of action, including wrongful trading claims, to third parties who are willing to fund and pursue such claims. This marks a significant change in policy, as it had not previously been thought possible to sell such claims to litigation funders, following a dictum of Peter Gibson LJ in Re Oasis Merchandising, Ward v Aitken [1998] Ch 170.

These reforms have increased the options available to liquidators and administrators who could not afford to pursue such claims. They also effectively require a liquidator or administrator to consider whether they should try to assign any wrongful trading claim which they have decided not to pursue themselves. However, while they make it more likely that a wrongful trading claim will be initiated, nothing in the reforms reduces the significant evidential burden involved in bringing a successful wrongful trading claim.

**Establishing wrongful trading claims – the practical and evidential challenges**

There is a fundamental problem with wrongful trading claims. They rarely succeed, as they are difficult to prove. It is largely for this reason that there has been, on average, only one reported wrongful trading case every year since the legislation came into force. Why is this?

> **Insolvency is not enough:** It is not enough to show that the directors knew that the company was insolvent and that, despite this, they carried on trading and incurring further losses. The wrongful trading regime differs, in this respect, from equivalent provisions in some civil law jurisdictions, where directors may automatically face personal liability if they continue trading after a company becomes insolvent.
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> **Directors’ belief in a turnaround:** The wrongful trading regime recognises that while a company might currently be insolvent, this could well be a temporary issue which will not necessarily lead to insolvent liquidation, as the company could be restored to solvency by improved trading conditions, new investment or a restructuring of its debt or business. Directors will therefore not be liable for wrongful trading if, at the relevant time, they had realistic grounds for believing that the company could still be turned round.

Establishing the exact point at which the directors should have realised that the game was up can prove difficult, particularly where their view was (for example) based on interest from a potential investor whose enthusiasm gradually waned over time. The difficulty in pinning down an exact time was highlighted in Re Ralls Builders, where the liquidators submitted that this point had been reached ‘by the end of July 2010, or at the latest by the end of August 2010’.

> **When did the wrongful trading commence?** The difficulties in establishing the precise point at which directors should have realised that the company no longer had a reasonable prospect of avoiding insolvent liquidation or administration are exacerbated by the fact that different dates may apply to different directors. Each director is judged by reference to both the standards reasonably expected of any director, and also by reference to their own particular skills and qualifications.

> **Directors are not judged with the benefit of hindsight:** While it may sometimes appear clear, with the benefit of hindsight, that the point of no return was reached and ignored, the wrongful trading regime cannot be used to penalise directors whose belief turned out to be mistaken, as long as that belief was reasonable at the time. As Lewinson J pointed out in Hawkes Hill Publishing Co Ltd [2007] BCC 937: ‘directors are not clairvoyant and the fact that they fail to see what eventually comes to pass does not mean that they are guilty of wrongful trading’.

> **Unsatisfactory records may assist delinquent directors:** The state of the company’s financial and other records often means that an administrator or liquidator will face an uphill battle when attempting to establish all of the elements of wrongful trading liability - the financial position of the company, its prospects and the knowledge of the directors. While they do have statutory powers allowing them to require assistance in reconstructing incomplete or inadequate records, the cost implications of carrying out such an exercise may act as a deterrent to pursuing a wrongful trading claim.

> **Are the directors worth suing?** Establishing whether a wrongful trading claim exists, and then pursuing that claim, can be expensive. Even if the various components of a wrongful trading claim can be proved, there may be little point in wasting recoveries which would otherwise be available to creditors in seeking redress from directors who have no material assets and who are not covered by either indemnity arrangements or D&O insurance cover which extends to wrongful trading claims.

**Re Ralls Builders – when establishing wrongful trading is not enough**

Despite these evidential difficulties, the High Court was satisfied in Re Ralls Builders that the company’s directors had been guilty of wrongful trading. In that case, a clearly insolvent company had been seeking a new equity investment from a seemingly wealthy third party, which would be used to restore the company’s balance sheet and to pay pressing creditors. It was held that while the directors had been justified in continuing to trade up to the end of August 2010, on the basis that there was still a reasonable prospect that this investment would be made, a realistic assessment at the end of that month should have led them to conclude that the potential investment could no longer be relied upon, and that there was therefore no longer any reasonable prospect of avoiding insolvent liquidation.

Despite this, the company continued to trade, and to incur new liabilities, from the end of August to October 2010, when the company eventually filed for administration.
The causation requirement: Snowden J further held that a liquidator or administrator pursuing a wrongful trading claim would need to establish that any identified increase in the net deficiency of the company’s assets had been caused by the directors’ actions during the period of wrongful trading. ‘Losses that would have been incurred in any event as a consequence of a company going into a formal insolvency process should not be laid at the door of directors under section 214’ and should therefore not be taken into account when making any contribution order.

On the evidence available, Snowden J was not satisfied that there had been any, or any material, increase in the net deficiency. Indeed, there may have been a ‘modest improvement’ during the period of wrongful trading. He therefore held that while the directors had been guilty of wrongful trading, and may have committed a ‘real sin’ in causing loss to individual creditors, the court was unable to make a contribution order. While that may be ‘a shortcoming in the structure of section 214’, it was not one that he could remedy. Instead, ‘any such change would be for Parliament’.

It’s not just a question of finding the evidence: the challenges involved in funding a wrongful trading claim

Even if it appears that the various components of a wrongful trading claim can be established, and the directors are worth suing, administrators and liquidators still need to consider how to fund such a claim. This process has been made more challenging by two recent developments:

> impact of the Jackson Reforms:
Representatives of the insololvency industry have argued that the end of the insolvency litigation exemption to the Legal Aid, Sentencing and Punishment of Offenders Act 2012, which came into force in April 2016 as part of the Jackson reforms, could make it harder for insolvency officeholders to economically justify pursuing claims. This is because legal success fees and ‘after the event’ insurance premiums can no longer be recovered separately and now have to come out of any award made against the directors, thereby reducing returns to creditors.

> costs: In addition, even if a wrongful trading claim is successful, there is no guarantee that a court will make a costs order in favour of a successful liquidator or administrator, as was illustrated by the recent decision in Brooks v Armstrong; Re Robin Hood Centre plc (in liquidation) (in the matter of costs) [2015] EWHC 2289 (Ch). In that case, the directors were ordered to pay compensation of £35,000 for wrongful trading, but the registrar decided not to make a costs order in favour of the liquidators, largely because the contribution ordered was (perhaps unsurprisingly, given the evidential issues involved) significantly less than the amount originally claimed by the liquidators.

While such developments may reduce potential recoveries for creditors from any wrongful trading claim, it does not necessarily follow that such claims are less likely to be pursued. These developments may just encourage administrators and liquidators to transfer claims to specialist litigation funders, some of whom have already issued statements suggesting that they are not unduly concerned by the Jackson reforms. This is not particularly surprising, as any resulting increase in costs will probably be passed on to the company, reducing the recoveries which would otherwise have been available to the company’s creditors.

The potential impact of third parties being willing to take on wrongful trading cases was recently discussed in Re Longmead Ltd (In Liquidation) [2016] EWHC 356, where a funder agreed to provide 100 per cent funding for a claim, together with a deposit of £1 million to provide cover against any adverse costs orders, in return for a substantial share of any recoveries.

Cases such as this present liquidators and administrators with a delicate commercial decision: is it in the best interests of creditors to fund a wrongful trading claim out of the insolvent estate, or would they be better off if the claim was sold to a litigation funder, thereby reducing both risk and potential reward? In reaching a decision, they should consider, on the basis of Snowden J’s judgment in Re Longmead, the merits of the case, the adequacy of the funds available in the liquidation or administration, the likely costs (and hence risk of diminution in future dividends) to which the company would be exposed if the claim were to fail and the proportion of the damages to be shared with the funder if the claim were to be successful.
Alternative options for bringing rogue directors to account

The fact that a liquidator or administrator does not have the evidence or funding to pursue a wrongful trading claim, or that the directors are not worth suing, is not necessarily the end of the story, as carrying on trading past the point of no return could result in either the disqualification of the relevant director or the making of a ‘back door’ compensation order. The making of a contribution order under section 214 is already a ground for disqualification under section 10 of the Company Directors Disqualification Act 1986 but Companies House statistics show that the last time a disqualification was made on this basis was in 1999. This ties in with the very small number of successful wrongful trading claims.

The SBEE has, however, introduced changes, particularly in relation to the factors which a court should take into account when considering whether to disqualify a director on grounds of general unfitness, which could make it more likely that a director who trades on past ‘the point of no return’, but who does not have a wrongful trading contribution order made against them as a result, could still face disqualification on grounds of general unfitness. The SBEE also gives the Secretary of State power to make a compensation order, or accept a compensation undertaking, in favour of individual creditors (or a class or classes of creditor) where a director has been disqualified for misconduct after 1 October 2015. While the most likely beneficiary of this will be the Crown (as most allegations of unfit conduct concern unfair treatment of the Crown), this power could potentially offer an alternative route to redress in cases such as Re Ralls Builders where creditors suffer as a result of wrongful trading but the court feels unable to exercise its discretion to make a wrongful trading contribution order.

Future developments?

In its March 2016 Inception Impact Assessment on insolvency harmonisation, the European Commission expressed a desire to consider common minimum standards for directors when a company is facing insolvency. This could potentially result in changes to the existing wrongful trading regime but the precise scope of any such work is currently unclear and, given the complexities involved in attempting to impose a common minimum standard for directors across Europe, this is unlikely to be a fast moving project.

In the interim, the current wrongful trading regime will continue. It remains to be seen whether the existence of litigation funders who are willing to take on these challenging claims will increase the number of contribution orders made against rogue directors and, if so, whether this ultimately benefits creditors as well as satisfying Vince Cable’s objective of holding ‘dodgy directors’ to account.