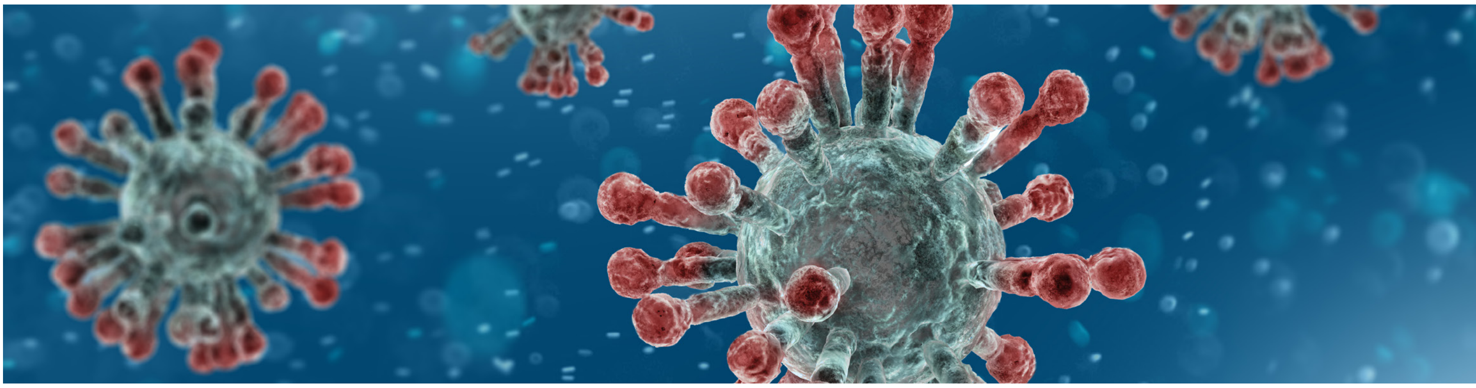
RPC

COVID-19: The suspension of wrongful trading provisions and a moratorium for businesses in restructuring: what is the likely impact on Insurers?



On 28 March 2020 the Business Secretary announced further new far-reaching measures to help businesses combat the financial impact of COVID-19. In a welcome intervention, the Business Secretary declared it was the government's intention to suspend wrongful trading provisions and to introduce a moratorium for businesses undergoing a restructuring process. Both measures are intended to assist companies to trade through financial distress caused by the loss of business due to the COVID-19 pandemic.

At this stage there is little detail in respect of the proposed legislation with the Business Secretary stating that such legislation would be introduced "at the earliest opportunity". Nevertheless, RPC restructuring and insolvency partner Paul Bagon commented: "The government's intention to introduce new measures to suspend director liability for wrongful trading will be welcome news to boards of directors around the country. Boards are encountering unprecedented challenges in assessing the ongoing viability of otherwise financially sound companies that are faced with the unexpected prospect of significantly reduced revenue for an unknown period of time".

In the event these changes fulfil the Government's policy objective and large numbers of COVID-19 related corporate insolvencies can be avoided, Insurers are likely to share in the potential benefits. In particular, the suspension of wrongful trading provisions should curtail the number of related claims under directors' and officers' liability (D&O) policies and measures reducing the number of insolvencies should limit potential Third Parties (Rights against Insurers) Act 2010 (the Third Parties 2010 Act) claims.

The Government, however, has also made it clear that the proposed reforms are not intended to limit other checks and balances governing directors' duties.

The sudden and unparalleled financial challenges imposed on companies of all sizes can be expected to give rise to an increase in claims against directors and recourse against Insurers under D&O policies. Furthermore, the stay of execution for otherwise unviable companies arising from the Government's intervention may make future underwriting assessments more difficult.

Temporary suspension of wrongful trading

In these uncertain times directors have become increasingly concerned about the risk of personal liability that can arise in respect of wrongful trading. Under current legislation a director can be liable if they are found to have continued trading a business and did not minimise losses to creditors at a time when they knew, or ought to have concluded, that there was no reasonable prospect of avoiding insolvent liquidation or administration.

The Business Secretary announced new legislation would be introduced to grant a temporary suspension of the wrongful trading provisions, which would take effect retrospectively from 1 March 2020.

Prior to the announced measures, wrongful trading provisions provided protection to creditors by imposing personal liability on directors of insolvent companies that continued trading beyond a time at which there was no reasonable prospect of the company avoiding insolvency. The aim of the proposed temporary suspension is to allow directors to continue trading distressed companies affected by the COVID-19 crisis without the risk of personal liability even in circumstances in which there is little clarity about the future prospects of the company avoiding insolvency due to uncertainty regarding when the COVID-19 crisis will end. Consequently, the measures should reduce the number of unnecessary and likely terminal corporate insolvency filings and allow viable companies to trade through the COVID-19 crisis and recover once normal trading activities resume.

One of the most difficult directors' duties decisions faced by boards of distressed companies relates to whether to drawdown on unutilised headroom under revolving credit facilities to provide much needed liquidity at a time when there is uncertainty about a borrower's ability to avoid insolvency. The relaxation of wrongful trading provisions during the COVID-19 crisis should enable directors to more easily evaluate such decisions and in so doing reduce the prospect of large numbers of companies becoming cashflow insolvent. Each such decision, however, will remain highly fact specific and to mitigate potential liability boards should continue to seek professional advice. In addition, as the proposed measures are universal and do not distinguish between businesses that were struggling prior to the COVID-19 crisis and those whose financial performance has been affected only by the pandemic, it is likely that the suspension of wrongful trading rules will enable so called unviable "zombie companies" to continue to limp on fuelled by low interest debt.

Moratorium

The Business Secretary also announced a moratorium for businesses which need to undergo a financial rescue or restructuring process which would allow them to keep trading for an extended period free from creditor action. Currently only small businesses (with 50 or less employees, turnover less than £10.1 million and less than £5.1 million balance sheet assets) can seek a moratorium when proposing a Company Voluntary Arrangement (CVA) and no such moratorium is available for businesses seeking a Scheme of Arrangement with their creditors. The introduction of additional moratoria for businesses implementing turnarounds through restructurings has been mooted for some time and was considered in the Government Consultation on Insolvency and Corporate Governance in 2018.

We await the Government's legislation for clarity on the exact scenarios in which businesses will be eligible to benefit from the proposals and the length of time the moratorium will be imposed. However, we would expect this to be similar to those currently granted to companies in administration or proposing a CVA, and as a minimum, prevent creditors from independently taking action to place companies in to liquidation or administration while the financial rescue or restructuring is ongoing.

We are also expecting, following the announcement by the Business Secretary, that provisions will be introduced to ensure businesses are still able to gain access to essential supplies. The extent of these provisions is unclear however we anticipate that they may expand the existing essential supplier regime set out in the Insolvency Act 1986 under which essential suppliers, such as utility and IT suppliers are prohibited from relying on an insolvency event as a trigger to terminate the provision of ongoing supply.

Consequences for Insurers

The main advantages to Insurers arising from the suspension of wrongful trading provisions is that it should prevent otherwise viable companies from filling for insolvency prematurely. This should limit claims against Insurers under D&O policies and the Third Parties 2010 Act.

Wrongful trading and D&O policies

For D&O underwriters, any steps taken to limit insolvency filings should be welcomed as it will reduce the number of claims for wrongful trading. This is because, absent fraud, wrongful trading claims may only be brought against directors in the event of a company's insolvency. Indeed, although ordinarily wrongful trading claims against directors are uncommon and mitigated by responsible boards seeking professional assistance, in circumstances in which even experienced directors are faced with unprecedented challenges there is a perfect storm of factors in which wrongful trading liabilities could arise, had the Government not intervened.

This "good news" however is tempered by the Business Secretary's warning that "all of the other checks and balances that help directors fulfil their duties properly will remain in force". Directors therefore must continue to act in accordance with their duties, both fiduciary and those codified in the Companies Act 2006. Those that do not, face the risk of personal liability, sanction and possible disqualification as a result of any misconduct.

Existing insolvency legislation, such as the rules around preferences and transactions at undervalue, remain. As such there is still a risk of significant claims under D&O policies. Indeed, if directors interpret the Government's relaxation of the wrongful trading regime too liberally, there is a risk of a greater number of claims against directors in the future on non-wrongful trading related grounds.

As RPC restructuring and insolvency Partner Finella Fogarty comments: "The proposed changes may be welcomed but do they really change anything? Very few directors are actually found guilty of wrongful trading and it may bring a false sense of security. It is the current intention that the majority of the existing legislation remains unchanged, and so directors will continue to need to consider and document very carefully decisions relating to creditor payments and asset disposals where there is a risk of the company entering insolvency and to seek relevant professional support to mitigate their risks in these areas".

Third Parties 2010 Act

Claimants bringing claims under the Third Parties 2010 Act against insolvent companies are permitted to require Insurers to defend the claims directly. In such scenarios, the directors and/or management of the insolvent company that possess knowledge of the claims are often unavailable or unwilling to assist post-insolvency. This requires Insurers to seek the assistance of the insolvency office holders (IPs) appointed to the insolvent companies, in circumstances in which the IPs may have limited knowledge of the claims and scarce resources. Consequently, the defence of Third Parties 2010 Act claims are often challenging and time consuming.

The Government's measures to reduce insolvencies should therefore be viewed as a positive move for Insurers as it should result in a lower number of potential Third Parties 2010 Act claims and requests for information being made directly against Insurers.

Underwriting risk

As a potential negative for Insurers the Government's measures could increase underwriting risk. As noted above, the suspension of wrongful trading provisions does not distinguish between viable and unviable companies. Consequently, it is possible that otherwise unviable insureds could seek to renew their policies at a time when, absent the Government's measures, they would have been insolvent. This may act to store up bigger problems for the future, and with it the claims insurers may ultimately receive. Underwriters therefore should be extra vigilant as to the financial health of the insured at renewal time. This is of particular importance in the professional indemnity market where lengthy run-off periods may apply.

RPC
16 April 2020

Paul Bagon
Partner
+44 20 3060 6646
paul.bagon@rpc.co.uk

Finella Fogarty
Partner
+44 20 3060 6158
finella.fogarty@rpc.co.uk

Tower Bridge House
St Katharine's Way
London E1W 1AA
T +44 20 3060 6000

Temple Circus
Temple Way
Bristol BS1 6LW
T +44 20 3060 6000

38/F One Taikoo Place
979 King's Road
Quarry Bay, Hong Kong
T +852 2216 7000

12 Marina Boulevard
38/F MBFC Tower 3
Singapore 018982
T +65 6422 3000