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ARTICLE

Directors' Duties in a COVID-19 World

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Synopsis

With a global pandemic causing unprecedented uncertainty for businesses, it has never been more difficult for the directors of UK companies fully to discharge their duties – and the risks when they do not do so have never been higher. Government schemes which seek to protect UK businesses may add to the pressure on directors to continue trading through financial difficulty, but it is essential that they appreciate what potential liability they face when doing so. Even if there were legal clarity as to the scope and content of a director's duty in respect of creditors' interests, discharging that duty is incredibly challenging when so much factual uncertainty exists.

Introduction

These are uncertain times. Events which only weeks ago would have been unfathomable to many in the business community have occurred with alarming speed. The effect on business is predicted by some to be worse than each recession since the Great Depression. Few sectors have been untouched by the pandemic. Major economies have ground to a halt. It is impossible to be certain if and when businesses will return to pre-pandemic normality and what 'new normal' might emerge.

It has never been more difficult for UK company directors to discharge the duties which bind them under the Companies Act 2006 ('CA 2006') and at common law. Already dealing with increasingly stringent governance requirements, increased risk of investigation and Parliamentary scrutiny, increased prevalence of shareholder class actions, a growing market in the trading of claims and legal reforms which increase the risk of personal liability (for example, the Pension Schemes Bill), directors are required to make decisions about the best interests of their companies in this uncertain landscape. Their doing so is complicated by the potential availability of untested tools (principally those created on an emergency basis by Government) to deal with the crisis. Never before in living memory have directors had to consider, for example, whether it is in the best interests of a company to furlough employees. For companies taking advantage of Government schemes, there is further uncertainty about what happens when those schemes end. For example, will they be able to afford to pay employees when they come off furlough?

This article (in which the law is stated as at 7 May 2020) focuses on the issues for directors of companies that are at risk of insolvency as a result of the pandemic. Successful directors, particularly of large and previously stable companies, do not often have experience of decision-making in these circumstances. They are being 'thrown in at the deep end' and will need quickly to digest how their duties are affected by insolvency risk. While directors are familiar with their core fiduciary duty to act in the best interests of their companies, the idea that best interests must be assessed by reference to creditors not just shareholders can feel alien.

Duty to promote the success of the company

Section 172(1) CA 2006 provides that directors must act as they consider, in good faith, would be most likely to promote the success of the company for the benefit of shareholders. The statutory wording appears to require directors always to act in shareholders' interests. However, both CA 2006 and the common law provide safeguards.

The section 172(1) factors

Section 172(1) identifies, non-exhaustively, six factors to which directors must have regard when discharging this duty, including the long term consequences of directors' decisions and the fostering of relationships with suppliers and customers. It does not prescribe how these factors must be weighed but is clear that they cannot override the obligation to act for the benefit of the company's shareholders. Though it is unclear what liability will attach to directors who do not have regard to these factors, directors are unlikely to be liable unless their decision was one that no reasonable director, having regard to the correct factors, would have taken.

Creditors' interests

Section 172(3) preserves common law rules requiring 'directors, in certain circumstances, to consider or act in the interests of creditors of the company.' Common law has not precisely identified when this duty arises or what is required of directors when it does.

The Court of Appeal gave the most recent and authoritative statement of the common law in *BTI 2014 LLC v Sequana S.A.* [2019] EWCA Civ 112, where David Richards LJ reviewed many earlier authorities. The court was asked to consider when the directors' duty to consider or act in the best interests of creditors, termed 'the creditors' interests duty', arose.

It is trite that directors do not owe any duty directly to creditors save in an exceptional case where directors have assumed responsibility to creditors (for example, by making a fraudulent statement to creditors or a negligent misstatement to creditors where the law imposes a duty of care). Directors continue to owe their duties only to the company. The issue is broadly when, in discharging their duty to promote the success of the company, directors must measure that success by reference to creditors not shareholders.

The claimant in *Sequana* unsuccessfully argued that the creditors' interests duty should arise when a company has a real, not fanciful or remote, risk of insolvency. Instead, the court held that the duty only arises when the directors knew or should have known that their company is, or is more likely than not to become, insolvent. The test as expressed in earlier authorities, using phrases like 'doubtful solvency', 'marginal solvency' and 'serious financial difficulty', was thus clarified.

Arguably, the court set the point at which the creditors' interests duty will arise quite late in a company's gradual decline, though that will provide directors little comfort given the impact of the pandemic has been anything but gradual. Setting the trigger too early could, per David Richards LJ, have a chilling effect on business because it could prevent directors from taking entrepreneurial risks due to a perceived need to preserve capital for creditors.

Though *Sequana* helpfully clarified when the duty arises, important questions remain unanswered:

– The Supreme Court was due to hear an appeal in *Sequana* in March 2020 but this was postponed as a result of the UK lockdown. It is now unrealistic to expect judgment until 2021. The claimant will ask the Supreme Court to hold that the creditors' interests duty arises at some stage before the company is or is more likely than not to become insolvent. It would be imprudent for directors of companies currently in financial difficulty to postpone all consideration of creditors' interests until such companies are or are more likely than not to become insolvent; any Supreme Court restatement about when the duty arises will have retrospective effect so that directors who rely on the Court of Appeal judgment might unwittingly be in breach of duty by failing to take into account creditors' interests when they should have done. While ignorance of the law is not generally a defence, if they act reasonably and honestly, and rely on appropriate legal advice, they may be excused of liability under section 1157 CA 2006.
– When the creditors' interests duty arises, what effect does it have? Are the directors required only to consider the interests of creditors and, if so, how should they be weighed against other stakeholders' interests? Or does the duty require directors to act in creditors' interests so that they prevail over all other stakeholders' interests? Neither *Sequana* nor earlier authorities clearly define the content of the duty – in *Sequana*, David Richards LJ stressed that this issue did not arise. As we explain below, in many cases its effect may not often matter.

Dealing with factual uncertainty

The directors' subjective determination of whether their company is or is more likely than not to become insolvent is relevant following *Sequana*. Companies' fortunes change, sometimes on a daily or hourly basis. A company may be more likely than not to become insolvent, but never actually do so. Companies may swing repeatedly between being likely to become insolvent and being likely to remain solvent. Directors constantly need to monitor whether the creditors' interests duty arises. How should they do so in the current environment?

Insolvency for these purposes is assessed on both a cashflow and balance sheet basis (as under section 123 of the Insolvency Act 1986 ('IA 1986')), by reference to the company's actual solvency position, not potential entry into an insolvency process.

Cashflow insolvency

A company is likely to become cashflow insolvent if it is more likely than not to be unable to meet its debts as they fall due. Put simply, is the company likely to run out of cash?

There are real difficulties with making that assessment currently. Market experience suggests that many companies preparing cashflow forecasts have assumed that they will have much reduced or no turnover for 3 to 12 months. It is unclear whether that is a correct assumption and, even when the current lockdown eases, whether and how quickly turnover will return to pre-pandemic levels. For companies with significant debts falling due in the medium term which they will be unable to meet unless income recovers in the same period, they may even now be more likely than not to become insolvent so that the creditors' interests duty arises.

As to expenditure, many businesses are reducing discretionary spending and cutting costs. Some outgoings may be met via Government schemes, though it is not certain how long these schemes will last and whether support will remain at current levels. The costs of operating businesses in the current climate and when lockdowns ease may increase, for example as a result of adjustments that must be made to respond to health concerns. It is unclear what adjustments may be required and what impact they may have on profitability, but their cost should not be underestimated. Even businesses which are perceived to be experiencing increased demand during the pandemic may not realise profits as a result. For example, supermarket Sainsbury's recently announced that it expected to suffer a substantial reduction in annual profits partly as a result of adopting safety measures for the benefit of its customers and staff. Online retailer Amazon announced that it might report an annual loss due to expanding its workforce, purchasing protective equipment and disinfecting its warehouses.

Turning to financing obligations, directors may need to re-assess when payments of principal and interest will become due. The pandemic has caused some companies to breach financial covenants with which they were previously unproblematic to comply. Other companies have potentially triggered events of default which are rarely considered in practice, for example in relation to cessation of a substantial part of a borrower's business, material adverse change and non-compliance with an approved business plan. Breaches and defaults will likely permit lenders to accelerate. Directors will be required to take a view on whether lenders are likely to accelerate and, if so, whether the company is likely to be unable to repay in full upon demand. The market has little experience of whether lenders will accelerate debts as a result of these breaches and defaults or whether waivers might be available; there is little precedent to inform directors' views. The likely stance of lenders is more difficult to predict due to their diversity – no longer are lenders exclusively banks – and the complexity of debt capital structures.

Assessing cashflow also requires a view to be taken by directors about their companies' counterparties. In many markets, companies which supply goods and services have not required payment on account. The recipients of those goods and services, anxious to preserve cash, may now seek to withhold or delay payment. Liability under invoices may ultimately be compromised at less than their value. Costly proceedings may be required in order to recover other liabilities. Though directors of these counterparties, at least if they are UK companies, might need to consider whether preserving cash in this way takes appropriate account of the need to foster business relationships with suppliers, being one of the factors listed under section 172(1) CA 2006, the reality for suppliers is that invoices are not being paid as they once were. Directors must consider this when forecasting cashflow.

The best protection for directors is to ensure that their cashflow forecasts use reasonable assumptions, that they genuinely believe them to be reasonable and that the forecasts cover an appropriate period.

Balance sheet insolvency

The balance sheet test is also difficult for directors to apply currently. The current pandemic has made it difficult to value assets and liabilities. For example:

- Where valuation turns upon the availability and robustness of a market, current market stagnation is likely to impact the accuracy and attractiveness of asset valuations.
- Where counterparties are unable or unwilling to pay, the debts due to a company may become more difficult to recover. This is likely to impact the value of the company's receivables (or require bad debt provisioning).

Again, the best protection for directors is to ensure that they are making reasonable assumptions, with appropriate valuation or accounting advice, and that they genuinely believe them to be reasonable.

Content of the creditors' interest duty

When the creditors' interests duty applies, what does it require of directors? There is little guidance in the cases.

When a company is actually insolvent, creditors' interests probably prevail over shareholders' interests because shareholders generally no longer have an economic interest in the company. Though this issue was not determined in *Sequana*, David Richards LJ stated that 'where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors' interests could be anything but paramount.'

Even this simple proposition begs questions in the current pandemic. The abrupt change to market conditions and the reaction of many companies seeking to preserve cash is likely to lead to a liquidity crisis, especially for companies in the supply chain. It will be risky for their directors to cause these companies to assume additional debt financing in circumstances where the company is uncertain to be able to make repayments. These companies may therefore already be more likely than not to be unable to pay their debts as they fall due so that the creditors' interest duty applies, despite having adequate assets to make whole all creditors were the company wound up with any surplus being paid to shareholders. Is it right that the interests of creditors should be paramount even where shareholders retain an economic interest in the surplus and it is only a single debt due to a single creditor which cannot be paid when due? The cases do not provide an answer.

Where the company is more likely than not to become insolvent but is not actually insolvent, it is still more unclear how the interests of shareholders and creditors should be balanced. Some academics and limited pre-*Sequana* judicial guidance suggest tentative support for a spectrum in which the more likely a company is to become insolvent, the more weight must be given to the interests of creditors. Put another way, the extent to which creditors' money is at risk affects the regard which must be had to their interests. *Sequana* confirms that the creditors' interest duty does not apply at all until the point on the spectrum at which the probability of insolvency is more than 50%, but does not address the weight of creditors' interests relative to those of other stakeholders beyond that point.

When this question is finally determined by an appellate court, creditors' interests may be held to prevail when a company is actually insolvent but not where a company is merely more likely than not to become insolvent, in which case creditors' interests must be balanced with other interests. It would then be up to the directors to form judgments as to the weight to be given to creditors' interests. Board members may disagree, potentially hampering decision-making and promoting stalemate, at precisely the time when quick and decisive action is required to give the company the best possible chance of survival.

Does the duty's content matter?

The lack of clarity as to timing and content of the creditors' interests duty, and the potential impact for directors' personal liability, can only add to the sense of concern and uncertainty that many directors will currently be experiencing. However, it is arguable that the creditors' interests duty will only rarely impact directors' decision-making or give rise to personal liability. The interests of shareholders and creditors often align – both wish the company to be successful so that they can be paid – so that it does not matter whose interests the directors actually considered.

Reported cases in relation to the creditors' interests duty tend therefore to arise out of transactions where the interests of shareholders and directors conflict, such that a decision in the interests of shareholders necessarily prejudices the interests of creditors. *Sequana* concerned the payment of a dividend to shareholders when, it was alleged, cash ought to have been preserved to meet the company's liabilities. Earlier cases concerned other shifting of value to shareholders: for example, *West Mercia Safetywear v Dodd* [1988] BCLC 250 concerned payment of money to a holding company and *Kinsela v Russell Kinsela Pty Ltd* (1986) NSWLR 722 concerned a lease granted to directors on favourable terms.

When the courts finally determine the content of the creditors' interests duty, it may be negative not positive – rather than requiring directors to act in or consider the best interests of creditors, it may require only that directors do not prejudice or ignore those interests when a company is actually or more likely than not to become insolvent. That is not a new idea, and was characterised by Professor Sealy as more akin to a duty of care than a fiduciary duty (see (1988) CLJ 175). This negative formulation of the common law duty would be similar to the statutory wrongful trading test, to which we return below. If this is the correct formulation, the duty will require directors to act differently to how they would in a solvent company principally where creditors' interests require assets to be preserved while shareholders continue to have an interest in the company taking entrepreneurial risk.

Why, then, do boards and their professional advisers spend so long considering the interests of creditors? The simple answer is that if creditors' interests are not properly considered, and if the company does enter an insolvency process, an administrator or liquidator may pursue claims against directors in relation to how the directors responded to the company's financial difficulties. Where directors acted to preserve assets which are available for distribution by the administrators or liquidators, they are less likely to be criticised. Favouring a cautious approach so as to minimise the consequences for creditors upon insolvency may also be thought to assist directors responding to post-insolvency investigations (including via the public forum of Parliamentary Select Committees) and disqualification proceedings.

However, too cautious an approach also puts the directors at risk. First, creditors' interests may be best served by continuing to trade, at least if there is real prospect of survival or an opportunity to realise profits with which to minimise losses to creditors in an insolvency process.

Second, if the creditors' interests duty does not require creditors' interests to prevail to the exclusion of other interests, logically the directors must continue to owe a residual duty relating to shareholders' interests. If the company ultimately recovers but does so more slowly due to an overly cautious approach being adopted, shareholder returns may be affected. Unlike creditors, whose only likely remedies against directors are via an insolvency process, shareholders can seek to sue directors in the name of the company via the derivative claims regime under Part 11 of CA 2006. Minority shareholders may also seek other relief in respect of unfair prejudice under section 994 CA 2006 (particularly where the board is largely comprised of majority shareholder appointees). This issue receives little attention but is a potential source of future litigation, especially given the increased prevalence of shareholder class actions and availability of litigation funding. While it may be difficult to imagine that directors who have successfully managed their companies through the pandemic, ensuring survival, will subsequently be criticised for taking too cautious an approach, and while courts are generally slow to find breaches of duty arising out of the honest and reasonable business decisions of directors, the possibility of shareholders de-risking litigation via funding and adverse costs insurance policies and shareholders' potential access to meaningful recoveries via a directors and officers' insurance policy could well encourage such claims.

Group companies

One aspect of the duty which is likely to have the most significant effect on day-to-day decision making in large corporate groups is the impact on ratification of directors' breaches of duty.

In a solvent situation, directors tend to identify the interests of group companies on a collective basis, reflecting the interests of the group's ultimate shareholders. This potentially gives rise to numerous breaches of the directors' duty to act so as best to promote the success of an individual company within the group, but such breaches can be ratified (including informally under the *Duomatic* principle) by each group company's shareholders.

When a group is in distress, the potential for different companies within that group to have different interests is increased. Some companies may be best served by taking on new debt. Others will be so reliant on their affiliates that their best hope of survival is to secure the affiliate's survival, perhaps via the granting of security or guarantees. Where the creditors' interests duty applies, *West Mercia* and other authorities confirm that shareholders can no longer ratify the directors' breaches.

Directors must therefore identify the interests of each individual group company and, for those companies that are or are more likely than not to become insolvent, must apply the creditors' interest duty. Failing to do so risks liability.

For groups which operate and are managed via group-wide divisional structures, effectively ignoring the separate legal personality of each entity within the group, it is often challenging accurately to assess the individual position of any single group company, more so if each group company is unable to continue trading without the support, services or personnel of its affiliates. As the Nortel Networks insolvency has shown, the costs ultimately borne by creditors when these divisional structures need to be unwound in insolvency can be very significant, as can be the time required to resolve disputes which arise between companies as to their relative entitlement to the proceeds of transfers of a business previously operated jointly by several entities within a group.

Wrongful trading

It is important to distinguish between the common law creditors' interests duty and wrongful trading liability under sections 214 and 246ZB IA 1986.

While the creditors' interests duty will arise wherever a company is more likely than not to become actually insolvent, wrongful trading focuses on directors' acts when there was no reasonable prospect of avoiding insolvent administration or insolvent liquidation. The statutory regime is therefore triggered when it is almost inevitable that creditors' money is at risk, yet requires directors only to minimise losses to creditors (a negative test). By contrast, the common law duty may arise long before insolvent administration or insolvent liquidation is inevitable, and might impose some form of positive duty on directors.

The differences are well illustrated when directors consider entry into administration to facilitate a company's rescue. In order to obtain an administration order, paragraph 11(1)(a) of schedule B1 IA 1986 requires that 'the company is or is likely to become unable to pay its debts'. This is the same test that triggers the creditors' interests duty at common law. However, if there remains a reasonable prospect of rescue via administration, and avoidance of insolvent administration, directors cannot be liable for wrongful trading. That remains the case even if the rescue subsequently fails and the administration becomes insolvent.

The Government has announced that the wrongful trading regime will be suspended in response to the pandemic, with retrospective effect from 1 March 2020 for three months. Legislation to implement this suspension is awaited. It appears that the Government's objective is to prevent directors prematurely placing companies into an insolvency process so as to minimise losses for creditors for fear that, if they do not, the directors themselves will be personally liable. Government's announcement referred to 'temporarily suspending wrongful trading provisions … for company directors so they can keep their businesses going without the threat of personal liability.'

However, it is not correct that companies in difficulty can continue trading without threat of personal liability for directors. Suspension of the threat of wrongful trading liability will place increased emphasis on the creditors' interests duty. If directors would have been at risk of wrongful trading liability but for its suspension, the common law duty must arise: if there is no reasonable prospect of avoiding insolvent administration or insolvent liquidation, the company must also be more likely than not to become insolvent. If the common law duty is a negative one, it may require directors to minimise losses for creditors just as would the wrongful trading regime. If the duty is a positive one, additional steps may also be required of directors.

What impact will the suspension have? Oddly, it could increase potential liability for directors. Directors are seldom criticised by the courts for seeking insolvency protection too soon. Courts tend to be sympathetic to directors who are, in difficult circumstances, doing all that they can to manage a company into an orderly insolvency process which will realise value for creditors. However, the suspension of wrongful trading laws, and the Government's message that directors can continue to trade without risk of personal liability, will increase pressure on directors to continue trading companies which should otherwise seek insolvency protection. The creditors' interests duty may not look kindly on them doing so.

Similar issues arise for other announced reforms. Government debt has been made available and companies are encouraged to use it, but it is still debt which directors should not take on if the company has no means of repaying it. Reforms to introduce a short moratorium during which directors will retain management control have been announced, but when should directors use this and what are their duties during the moratorium period? Ordinarily, companies benefitting from moratoriums are managed by insolvency practitioners who are well used to that role, not by directors who may have little relevant experience. With each scheme or reform announced by Government, directors are being required to answer questions which have never been asked previously.

The continued importance of other duties

Amongst detailed discussion of the creditors' interests duty during the pandemic, directors must not forget their other duties. It is, in truth, relatively easy for an honest director to ensure compliance with the creditors' interests duty because, even though the trigger for the duty incorporates an objective element where the directors should have known that the company was or was likely to become insolvent, the duty itself is subjective. Directors will not be liable if they do what they honestly think best protects creditors' interests. Further, it is relatively rare for the interests of shareholders and creditors to diverge such that directors need choose between them. Even in acute financial difficulty, maximising the value of the company and taking reasonable steps (as opposed to costly gambles) to seek to ensure its survival will often serve both shareholders' and creditors' interests.

If directors should have realised that the company was more likely than not to become insolvent, they will not automatically be liable for breach of duty simply because they did not and failed to take any account of creditors' interests. They may have reached the same decision had creditors' interests been considered or the company's position may have been so dire that, no matter what decision the directors made, the company would have ended up in the same position – in either case, the directors' decision will not have caused loss to the company. Further, if a reasonable director, having taken into account creditors' interests, could have reached the same decision as the directors actually did (absent consideration of creditors' interests), the directors may not be liable: *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch). Even if they are liable, directors' liability can be excused under section 1157 CA 2006 where they acted reasonably and honestly.

It is uncommon for directors to be sued solely for breach of duty where establishing fault turns on the subjective belief of the directors. Breaches of other general duties are more easily proven. Directors will be in breach of duty under section 174 CA 2006 if they fail to exercise the level of skill, care and diligence that a reasonable director having the same knowledge, skill and experience would have exercised. This duty is likely to be broad enough to catch costly gambles made in an attempt to ensure a company's survival. Equally, it can likely catch a director's decision to continue trading when a reasonable director in the same situation would not have done so.

Other duties also create traps for the unwary. Directors cannot take advantage of their company's business opportunity, absent prior authorisation, even if the company is unable to pursue the opportunity due to insolvency: *Davies v Ford* [2020] EWHC 686. Consider a group of companies with common directors, where opportunities are made available to the group and the directors allocate them between companies. Absent prior authorisation, each allocation is *prima facie* a breach of duty – one group company's interests are prioritised over another's. If shareholders cannot ratify the breach because the creditors' interest duty has arisen, a subsequent insolvency officeholder can sue directors for breach and potentially obtain a remedy not only against them but also the group company that took up the opportunity.

And it is not only directors' general duties that must be observed. For example, directors remain required under section 363 CA 2006 to ensure that a company's accounts give a true and fair view. With all of the uncertainty caused by the pandemic and its effect on many aspects of a company's balance sheet, this is not straightforward even with the benefit of skilled advice.

Conclusion

Directors are being asked in this crisis to step up to a role which is alien to many, carrying their companies through distress and continuing to trade even where insolvency is likely. It has never been more important for directors to understand their duties in these circumstances. While the Government is hoping that directors will steer businesses through, where companies do fail, it is unlikely that directors' decisions will avoid critical scrutiny. For directors, the risks have never been higher.

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