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When am I deemed to be trading wrongfully?

In the light of hits being taken by businesses resulting from the Covid pandemic, **Advocate Raymond Ashton** looks at the matter of trading through insolvency

(Shutterstock picture)

ONE of the questions I am frequently asked by directors at the moment is, when am I deemed to be trading wrongfully?

The relevant section (434) of the Companies law in this regard can apply where a liquidator, creditor or member of the company applies to the court to the effect that some time before the commencement of a liquidation, that a person (usually a director) knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into liquidation. This requirement is modified somewhat when the director can show he took every step to minimise the potential loss to the company's creditors that he ought reasonably to have taken. This would cover where a sole director's actions over a period of time resulted in the deficit in the profit and loss account not increasing over the period under review. In this situation this would protect the director.

This is further clarified by subsection (4) which states that in relation to the facts he ought to have known, the conclusions he ought to have reached and the steps which he ought to have taken are those which would be known, reached or taken by a reasonably diligent person having the general knowledge, skill or experience:-

a) that may reasonably be expected of any person carrying out the same functions as are carried out by the director, and

b) of that director

In other words a person who is not sufficiently qualified is to be tested by reference to someone who is ideally qualified whilst someone who is over-qualified is to be tested by the higher standards they possess.

The fact that a company is trading whilst insolvent does not in itself mean that it is wrongful. It is only if there is not a reasonable prospect of not going into insolvent liquidation.

Thus, if before the first pandemic the company was trading profitably the fact that there were losses in the pandemic and for some time after, including the current one, would not be catastrophic. In making his decision it might be appropriate to take into account any tax relief or tax repayment attributable to the losses or other special payments. The clearest statement of the obligations on a director are set out in the statement by Chadwick, J, as he was then Secretary of State for Trade & Industry v Taylor (1997) IWLR 407.

The companies legislation does not impose on directors a statutory duty to ensure that their company does not trade while insolvent; nor does that legislation impose an obligation to ensure that the company does not trade at a loss. Directors may properly take the view that it is in the interests of the company and its creditors that, although insolvent, the company should continue to trade out of its difficulties. They may take the view that it is in the interests of the company and its creditors that some loss making trade should be accepted in anticipation of future profitability. They are not to be criticised if they give effect to such views, properly held.

Obviously there is difficulty in deciding with hindsight whether it was wrongful to continue trading.

The first significant case was Re Produce Marketing Consortium Limited (No 2) (1989) 2BCLL520. This company traded as a fruit importer, initially successfully but over time the profitability declined and the company went into creditors' voluntary liquidation. The company showed a decline from one with no overdraft to a substantial one with an excess of liabilities over assets. Knox, J, held that whilst they did not have accounts they should have realised there was no way of trading out of the situation with the directors knowing the business intimately.

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>
> **Advocate Raymond Ashton, pictured left**

It is important to point out that this was a simple case of a fruit importer where produce was bought and sold, a very simple production process. Greater vigilance is needed where there is a complex production process where a view has to be taken of the value of work in progress. The value of this may change over time and this is something that should be taken into account on a regular basis.

The question of wrongful trading is a question of fact and degree. This is crucial, but the more complex the production process the more difficult the decision. This in the case of engineering the decision is likely to be more difficult than in the case of a simple retail shop.

The other significant factor which emerges from the cases is the use of accounts. Too often this writer has seen this business exercise taken by not having accounts available. This factor can be the key to avoiding liability for wrongful trading and the nearer the accounting date to the insolvency date, the more convincing will be the claim for no liability for wrongful trading.

The lesson is simple: accounts prepared by a qualified accountant is indispensable to this decision.