COVID-19 and Insolvency
Are business owners still liable for the offences of wrongful and fraudulent trading?

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Introduction

With the effects of COVID-19 reducing business revenue, business owners must ensure more than ever that their businesses have sufficient cash reserves and cash flow to ensure that they do not inadvertently expose themselves to insolvent trading. We understand that Australia announced on 23 March 2020 a temporary relaxation of its insolvency laws.

For a period of 6 months, directors will be relieved of their duty to prevent a company from trading whilst insolvent with respect to debts incurred in the ordinary course of carrying on its business. Such a move has not been announced by the Government of Jersey and so, at least for the time being business owners in Jersey still have a statutory duty to not trade whilst insolvent. This briefing note provides an overview of the offences directors could face if they permit a company to trade whilst insolvent.

When is a Jersey company in financial difficulty?
A company is deemed to be in financial difficulty when it is unable to pay its debts as they fall due (i.e. it is cash flow insolvent).

What options are available to an insolvent company?

If a company enters financial difficulty it's directors could:

- commence a Creditors' Winding Up; or obtain a declaration that it's property be declared
- en désastre.

Do these have to be pursued immediately?

The directors are not obliged to commence either of these processes. It may not, for example, be necessary to commence these if there is a reasonable prospect of trading out of the difficulty with careful management.

However, on occasions these processes may be the best way of protecting the creditors' interests.

What are the duties of a director when a company is in financial difficulty?

It is very important to note that when a company enters financial difficulty, the directors' duty changes from acting in the best interests of the company (i.e. its shareholders) to acting with a view to minimising the loss to the company's creditors.

What happens if a director does not act in accordance with this duty?
If a director does not further this duty, they could be deemed to have been permitting the company to be wrongfully and or fraudulently trading and could also, in severe circumstances, be subject to a disqualification order (as to which see below) and also criminal prosecution.

Wrongful and Fraudulent Trading
What is the test?

The test for Wrongful Trading, is set out in both Article 177 of the Companies (Jersey) Law 1991 (the Companies Law) and Article 44 of the Bankruptcy (Désastre) (Jersey) Law 1990 (the Bankruptcy Law), namely:

If a director knows or ought to have known on the facts known to them that there is no reasonable prospect of avoiding a creditors' winding up or a désastre.

The test for Fraudulent Trading, is set out in both Article 178 of the Companies Law and Article 45 of the Bankruptcy Law, namely:

If a director knows or ought to have known based on the facts known to them that the business of the company has continued, notwithstanding the company's financial difficulty with the intent of defrauding anyone and or with the intent of furthering a fraudulent purpose.

What happens if a director is declared to have been wrongfully and or fraudulently trading?

A court may order that the director be held personally responsible and liable for any and all debts incurred after the director became aware or ought to have been aware that there was no reasonable prospect of avoiding insolvency and or that the company was furthering a fraudulent purpose.

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As mentioned previously a disqualification order could also be sought, along with criminal prosecutions.

Are there any defences?
In respect of Wrongful Trading, a director will not be liable if a court is satisfied that when the director knew there was no reasonable prospect of avoiding insolvency, they took reasonable steps to minimise the potential loss to the creditors.

What is reasonable will depend on the circumstances. However, generally speaking not every potential avenue to minimise creditor loss necessarily needs to have been explored, but conversely a complete failure by the directors to take / document any steps to mitigate a business's potential losses, is a risky strategy.

In respect of Fraudulent Trading, the burden of proof rests with the accuser. If the accuser is unable to prove this beyond reasonable doubt that there was an intent to defraud someone else, it is unlikely that the Court will not declare a director to have been fraudulently trading.

How can these defence be evidenced?
Ultimately this depends on a case by case basis. If a director does become concerned about a company's financial position there are a number of practical steps that can be taken to help demonstrate that reasonable steps are being taken with a view to minimising the potential loss to creditors. These include, amongst other things:

- Paying close attention to daily cash flows and liabilities including timetables and financial milestones for raising additional funds.
- Holding regular board meetings (and ensuring they are documented) to review the financial position of the company.
- Obtain professional advice on how to proceed and minimise the effect to creditors.
- Ensure that potential sources of additional capital are reviewed and pursued where necessary.
- Ensure that the company avoids, as far as possible, incurring fresh liabilities it may be unable to meet.
- Ensure negotiations begin with creditors to postpone payments or to introduce caps to liabilities which may arise if payments cannot be made.
- Review the terms of the directors and officers insurance.

Ensure that accurate and detailed records are kept of all advice received and the steps taken.

To the extent that a director does not agree with a decision the company takes, it is also important that such director keeps their own personal records of that event and their reasons for disagreeing with the majority of the board and they take steps to ensure the disagreement is evidenced in the company's books and records.

What if a director resigns?
Simply resigning when a company is in financial difficulty does not absolve a director from liability for the above offences. The directors have a duty to act in the best interests of a company. The act of resigning may in certain circumstances in fact enhance the possibility of a director being convicted.

Disqualification Order
Article 78 of the Companies Law permits the Attorney General, the Jersey Financial Services Commission or the Chief Minister if it is in the public interest, to seek an order for a director's disqualification. For an order to be imposed, the Court must be satisfied that the director is 'unfit' to act as a director and their behaviour is of a serious nature.

It is important to note that ordinary commercial misjudgment will not generally be sufficient to justify an order. The same can be said for continuing to trade and seeking additional investment and funds, provided it can be shown that such actions offered a reasonable prospect of minimising losses to creditors.

This briefing is only intended to give a summary of the subject matter. It does not constitute legal advice.

If you would like legal advice or further information, please contact us using the details below.

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