PrivateEdge

Wrongful Trading

Where a director allows a company that is in financial trouble to continue to trade the director may become liable for "wrongful trading". This article looks at what wrongful trading is, what exposure it could lead to, and practical steps that directors should take to avoid incurring liability.

What is wrongful trading?

Wrongful trading occurs when:

1. a company has entered insolvent liquidation or insolvent administration;
2. the directors of the company continued to trade past the point when they knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration; and
3. the directors did not take "every step with a view to minimising the potential loss to the company's creditors".

Any director who knows (or ought to know) that there is "no reasonable prospect" of avoiding insolvent liquidation or insolvent administration, but continues to allow the company to trade, therefore runs the risk of becoming liable for wrongful trading.

However, it is important to appreciate that it is not necessarily wrongful trading for a director to allow a company to continue to trade while it is insolvent. In some situations, if the directors genuinely believe that the position will be turned around and the position of creditors will improve, continuing to trade may be the correct thing to do. When it becomes wrongful trading is when the directors realise, or should have realised, that there was no reasonable prospect of the company being turned around.

Who may become liable for wrongful trading?

Any appointed director of the company, whether executive or non-executive, may become liable for wrongful trading, as may other persons who whilst not appointed as directors, have acted as if they were, for example a controlling shareholder.

What is the exposure?

If a director is guilty of wrongful trading the court may make an order requiring the director to contribute to the assets of the company. The level of contribution is at the court's discretion but is likely to be calculated by reference to the amount necessary to compensate creditors for loss suffered as a result of the company continuing to trade beyond when the directors ought to have allowed. The court may also make an order disqualifying the director from acting as a director in the future.

Who can bring a claim for wrongful trading?

A wrongful trading claim may be brought against a director by a liquidator (if the company enters insolvent administration), or by the administrator (if the company enters insolvent administration). Legislative changes have also been introduced recently which permit liquidators / administrators to assign (i.e. transfer) the right to bring a wrongful trading claim to others (e.g. one of the company's creditors). It is possible that this change may lead to more wrongful trading claims being made against directors in the future.

Practical steps

There are a number of practical steps that directors can take to protect themselves from liability for wrongful trading. These include:

1. Ensure up-to-date accounts are kept;
2. Hold board meetings frequently, and make sure that minutes are kept;
3. Keep creditors informed and seek their support for the continued operation of the company.

If a director realises that his or her company is insolvent and that a turn-around may not be possible, one important thing for him or her to consider is seeking immediate professional advice from a licensed insolvency practitioner.

Directors will not be liable for wrongful trading, provided they have taken "every step with a view to minimising the potential loss to the company's creditors".

However, it will not always be clear whether the company should continue to trade, or (if it should) what steps should be taken to protect creditors. Seeking help from expert professionals is likely to help protect directors from potential liability.

In some situations it may be necessary to consider ceasing trading and putting the company into administration or liquidation, as the only practical means of protecting the directors from liability for wrongful trading.

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