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As well as serving as a useful reminder of the law surrounding wrongful trading and the operation of section 214 Insolvency Act 1986, this recent High Court decision clarified where the burden of proof lies in defending a wrongful trading case.

Background

When a company goes into liquidation, the liquidator is empowered to investigate the actions of the directors during the period leading up to liquidation. On the application of a liquidator, the Court may require a contribution to the assets of a company from a person who is or was a director of the company which has gone into insolvent liquidation and at some point before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into such insolvent liquidation. This is known as wrongful trading and is governed by section 214 Insolvency Act 1986.

The High Court has held that personal liability on the part of a director under section 214 only arises if, on a net basis, it is shown that the company is worse off as a result of the continuation of trading; the court will not make an order for wrongful trading if, knowing there was no reasonable prospect that the company would avoid going into insolvent liquidation, the director took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken. The facts that a director of a company ought to know or ascertain, the conclusions that he ought to reach and the steps that he ought to take are those that would be known or ascertained, or reached or taken, by a reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general knowledge, skill and experience which that director has The test is therefore both subjective and objective.

Dishonesty is not required and, as such, there a lower burden of proof than that required to prove fraudulent trading. It is therefore considerably easier for a liquidator to obtain an order for wrongful trading than for fraudulent trading.

In the recent case of Brooks v Armstrong (which is also known as Joint Liquidators of Robin Hood Centre Plc v Armstrong) the directors of Robin Hood Centre Plc had, in October 2006, received professional advice about a large VAT liability and sought a review from Revenue & Customs. In May 2007 the directors received a letter from Revenue & Customs stating that the VAT liability had been confirmed on review. The liquidators claimed that the directors had wrongfully traded in the knowledge that the company had no reasonable prospects of avoiding insolvent liquidation. The company entered liquidation on 6 February 2009. The joint liquidators of Robin Hood Centre Plc subsequently applied for orders that the directors contribute to the assets of the insolvent company under section 214.

Decision

On 31 July 2015 the High Court decided that once the liquidators could establish that the directors knew or ought to have known that there were no reasonable prospects for a company to avoid insolvent liquidation, it was for the directors to establish that they had done everything in their power to minimise the potential loss. The liquidators did not bear a burden of proving that the directors did not take all necessary steps.

Further, the liquidators did not need to prove that the directors had the knowledge at a particular date; it was sufficient to show that the directors had this knowledge at some time before the winding up took place. There was no duty not to trade while insolvent if the directors predicted the company would achieve profits in the foreseeable future. In this case, applying the reasonably diligent director test, the adverse consequences of liquidation when balanced against the potential benefits of trading meant that the directors had taken the right course of action by initially continuing to trade. However, the circumstances changed with receipt of the May 2007 letter from Revenue & Customs. In continuing to trade, whether the directors had minimised the loss had to be judged by reference to the body of creditors as a whole. In continuing to trade, the directors may have ensured that the company's trade creditors were paid, but the VAT and rent liabilities were not being paid, so the liabilities to the creditors as a class were increasing. The directors should therefore have known that the company had no reasonable prospect of avoiding insolvent liquidation.

Commentary

This case serves as an important reminder of how section 214 operates and, importantly, provides clarification as to who carries the burden of proof in respect of a director's defence that he had taken every step to minimise the potential loss to the company's creditors.

For further information, please contact James Walton or the Partner with whom you usually deal.