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# ARTICLE

## *Nicholson*: Decision to Keep Trading Not Always Wrongful

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### Key points

- In the recent case of *Nicholson and another v Fielding and others [2017] All ER (D) 156 (Oct)*, the English High Court refused an application by the liquidators of a company to hold its former directors liable for wrongful trading, despite significant losses being suffered by creditors.
- The ruling illustrates that a decision to continue trading while in financial distress (particularly in times of heightened uncertainty in the wider economy) is not always a ground for wrongful trading liability.
- The case is a useful barometer of the flexibility accorded directors of companies in financial distress, while also demonstrating that the regime actively encourages directors to keep accurate records of all decision-making.
- Quantifying the claim correctly is critical. The Deputy Registrar found that the liquidators in this case did not submit a proper account of the increase in net deficiency in assets caused by the alleged wrongful trading. As the company had kept exemplary accounting records, the Deputy Registrar held there was no excuse for this oversight: had the wrongful trading claim been successful he would have awarded the liquidators nothing.

### Wrongful trading

Under the Insolvency Act 1986 directors and former directors may be required to contribute to the company's assets on entering insolvent liquidation (section 214) or insolvent administration (section 246ZB). Liability arises where the director or former director knew, or ought to have concluded, that there were no reasonable prospects of the company avoiding going into insolvent liquidation or entering insolvent administration. However, the court shall not make an order where the director or former director took every step with a view to minimising the potential loss to the company's creditors as that person ought to have taken.

The test is both objective and subjective. What the director or former director *ought* to have concluded is assessed by reference to the knowledge, skills and experience that a reasonably diligent person in that person's position may reasonably be expected to have, and the actual knowledge, skills and experience that the defendant director did, in fact, have. There is no requirement for dishonesty by the director.

The provisions, known as wrongful trading after the title of section 214 and section 246ZB, are one of the main ways that English law encourages directors to focus carefully and appropriately on the prospects of a company in financial difficulty. Whilst the regime is relatively flexible, the consequences of getting it wrong can be severe. The concern of directors to avoid this personal liability is therefore often a helpful catalyst to 'do something', whether that be to take steps to implement a solvent restructuring or commence insolvency proceedings.

Identifying the point in time at which a director ought to know that there are no reasonable prospects of avoiding insolvency can be difficult in practice. There is no prescribed test of a company's accounts that determines this. Directors are entitled to decide that a company should continue to trade for a time while loss making in anticipation of future profits. Accordingly, the court will look at what options were available to the directors, and the reasonableness of the belief that these options would save the company. The result is that the decision in each case is very fact specific. As few wrongful trading claims are brought to trial, this makes it difficult to draw out many general principles concerning when the relevant point in time has been reached.

Once it has been determined that the relevant point has been reached, the court must consider what loss has been caused to the company. The approach to this question was considered in some detail in the landmark case of *Re Ralls Builders Ltd [2016] EWHC 243 (Ch)*. It was held that the correct approach is to measure the increase in the net deficiency of assets in the company over the period from the time the directors first ought to have realised there was no reasonable prospect of avoiding insolvency, up to the point the company actually went into insolvent liquidation or administration.

Where there is no increase in net deficiency in this period, the court will not make an order.[1]

In relation to the 'every step' defence, described above, under section 214(3) Snowden J held in *Re Ralls Builders* that it is a high hurdle for directors to surmount. If one group of creditors suffers disproportionate losses, the directors will not be able to rely on the defence where they attempt to mitigate the losses to creditors generally, or to another specific group of creditors.[2] As the defence is so exacting, in practice it is rare that directors are comfortable relying on it. Instead, directors and their advisors tend to focus on ensuring the directors are outside the wrongful trading regime in the first place and, in case they are within the regime, assessing the risk of liability based on an increasing deficiency of assets. The decision in *Nicholson* shows the court may be prepared to grant significant latitude to directors in these respects.[3]

## The decision in *Nicholson*

The respondents in *Nicholson* were former directors of Mainland Car Deliveries Limited ('Mainland'), which transported new and used cars for manufacturers. The company was severely impacted by the aftershock of the financial crisis and showed a net deficiency of assets from July 2008. To mitigate cash flow problems, the company juggled creditors, and from March 2008 it fell behind on PAYE and NIC payments to HMRC. Several payments were missed altogether and never paid. The directors engaged external advisers and corresponded with HMRC to work towards a repayment plan to enable the company to continue to trade. This continued until HMRC presented a winding up petition in August 2009. Mainland went into administration in October 2009 and into liquidation in July 2010.[4] The liquidators sought a declaration that the directors knew or ought to have concluded that Mainland had no reasonable prospects of avoiding insolvent liquidation, either at 1 June 2008 or at 31 October 2008.[5]

Deputy Registrar Prentis, who heard the case, held that the directors could not benefit from the 'every step' defence, following the analysis in *Re Ralls Builders*.[6] The directors took steps that were designed to postpone the debts of one creditor, HMRC, but not others. However, the Deputy Registrar felt unable to conclude that the directors knew or ought to have known that there were no reasonable prospects of avoiding an insolvent liquidation.

### *The effect of economic uncertainty*

In an analysis of the directors' conduct in the relevant period, the Deputy Registrar referred extensively to the economic circumstances in which they made decisions. He noted that:

> 'The question of wrongful trading cannot be addressed by looking at the Company's business in an economic vacuum. It was operating in a market direct[ly] affected by the global financial shock, not only in the cost of financing but in its core business.'[7]

The problems faced by the business carried significant uncertainty. As the market contracted, sales fell severely, falling by 15.1 *per cent.* in 2008 compared to the previous year. Several major contracts were delayed as manufacturers sought to reduce their own exposure. Simultaneously, fuel costs rose dramatically, to which Mainland was particularly exposed as it bought its fuel weekly rather than through futures.[8] The Deputy Registrar further found that the car haulage industry had a practice of very short notice periods for varying the contractually agreed volumes and prices for orders, leaving the company unable to predict long term revenues with much accuracy.[9] In this context, he found that the directors were doing their best to take account of those variables, and could not be held accountable for not predicting their full effects.[10]

### *Attempts to save the business*

The Deputy Registrar found that the management accounts for the company were exemplary and that the directors were clearly monitoring the performance of the company and re-evaluating their strategy in light of the latest developments. The decisions taken by the directors had included laying up unused equipment, making redundancies, applying pressure to speed up payment of existing invoices, reducing an invoice

*Notes*

1 *Grant v Ralls (Re Ralls Builders)* [2016] EWHC 243, paras. 241 and 268.
2 *Re Ralls Builders*, paras. 245-246.
3 Other recent cases which consider issues relating to this field include *BTI v Sequana* [2016] EWHC 1686 (Ch) and *Ball (Liquidator of PV Solar Solutions Ltd) v Hughes and another* [2017] EWHC 3228 (Ch).
4 *Nicholson*, paras. 5-21.
5 *Nicholson*, para. 22.
6 *Nicholson*, para. 109.
7 *Nicholson*, para. 62.
8 *Nicholson*, paras. 62-63.
9 *Nicholson*, para. 65.
10 *Nicholson*, para. 98.


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discounting facility to save on costs, and engaging an external adviser to independently assess its position. The company also continued to bid for, and win, major contracts with new and existing customers.

Importantly for the directors, the correspondence with HMRC over the deferral of payments contained detailed consideration of the company's changing position and evolving strategy. It therefore supplied much of the evidence on which the Deputy Registrar relied in order to conclude that the directors were constantly re-evaluating their options.

### *The directors' track records*

Prior to their directorships of Mainland, two of the respondents had been involved in managing its predecessor company (referred to in the judgement as Oldco) which had entered administration in 2006. The Deputy Registrar found that their experience was relevant to the wrongful trading claim in two respects. First, as they had experience of the factors which could tip a company within their industry into insolvency, the respondents 'should have been warier than the average director.'[11] This indicates that prior experience of insolvency affects the standard of what is reasonable diligence (although, in this case, the Deputy Registrar found that in light of the 'extraordinary influences on their industry' (summarised above) the point does not go very far[12]). Second, the respondents had many years of successful trading experience as directors of Oldco.[13] This suggests that industry experience is relevant in considering the reasonableness of the options directors pursue to save the company.

### *Quantifying the claim*

Following *Re Ralls Builders*, the correct approach to quantifying the maximum contribution of directors under a wrongful trading claim is to provide a proper account of the increase in net deficiency of assets over the relevant period. The Deputy Registrar recognised that, if insufficient financial data is available, a simplified approach may be taken where the court estimates the net deficiency increase for the relevant period by pro rating an increase between two dates with known data. In this case the liquidators relied on a comparison of the figures in the statement of affairs when the company went into administration and the balance sheet as at 31 October 2008.

It was held that this was the incorrect approach on two counts. First, that as sufficient financial information was available, a proper account should have been based on the available *management* accounts for the period and compared to what the position would have been on an earlier liquidation. Second, that reliance on a statement of affairs from 2009 was 'utterly inappropriate'.[14] There was uncertainty as to whether any of the creditors had been paid since the statement of affairs was drafted, as a third party took over Mainland's business and may have paid creditors – which would have been the situation on an earlier liquidation in any event. The importance of applying the correct approach was highlighted by the Deputy Registrar, who held that, had the wrongful trading claim been successful, he would not have made an order for a contribution, on the basis of the failure to properly quantify the loss to the company. He said:

> 'It would have been for the liquidators to satisfy me that there is a recoverable loss. On the evidence, any figure I came to would be a stab in the dark. That does not discharge the burden of proof.'[15]

## Comment: good news for pro-active directors

This decision is likely to be an encouraging development for directors who face rapidly changing circumstances in times of financial difficulty.

Directors of struggling companies must inevitably strike a balance between two courses of action. On the one hand, if they conclude that an insolvency process is required, they must start the insolvency process early enough to protect creditors so far as possible and to avoid the risk of personal liability; on the other, they must allow time to explore the options for the company's survival as exhaustively as possible. English law has traditionally allowed directors a fair amount of latitude and flexibility in navigating this difficult balance. *Nicholson* is a helpful barometer of where the parameters of that balancing act now lie.

Clearly, directors' responsiveness to events will be important in determining whether liability arises, but another key issue is whether their assessment of the company's prospects will be considered credible. Directors should take care to gather all relevant information and continually re-evaluate their options in light of professional advice and experience. Where this is done thoroughly, and carefully recorded, the directors' position is likely to be strong.

*Notes*

11 *Nicholson*, para. 99.
12 *Nicholson*, para. 99.
13 *Nicholson*, para. 99.
14 *Nicholson*, para. 113.
15 *Nicholson*, para. 115.


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