

English Court Imposes >£18 Million Personal Liability on Former Directors of BHS for Breach of Directors' Duties and Wrongful Trading

12 JUNE 2024

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At a Glance

- ▶ The English Court yesterday issued its 533-page [judgment](#) in the claim brought by the liquidators of British Home Stores, the major UK retailer, against two of its former directors.
- ▶ Upholding the liquidators' claims, the Court granted the largest-ever UK wrongful trading award and the first-ever award for "misfeasant trading".
- ▶ The Court examined in great detail the events and decisions surrounding BHS' acquisition by Retail Acquisitions Ltd (**RAL**), the subsequent attempts to restructure and refinance the business, and the ultimate failure to secure adequate funding, leading to BHS' collapse. Unusually, the case against the principal director/shareholder, Dominic Chappell, was "severed" from that against other directors and remains to be determined.
- ▶ The Court held the two directors liable for:
 - **wrongful trading**, for £6.5 million each, toward a £45 million increase in net deficiency in the companies' assets between the date on which (a) the directors knew, or ought to have known, that there was no reasonable prospect of avoiding insolvent liquidation or administration (September 2015) and (b) the companies actually filed for administration (April 2016, c.7 months later);
 - "**misfeasant trading**" – a novel claim for breach of statutory duties in continuing to trade, including failing to have sufficient regard to creditors' interests (when, if directors had complied with their duties, the companies would have entered administration in June 2015, c.10 months earlier);
 - ▶ the quantum of this liability will be determined in due course, but could be up to £133.5 million (again, representing the increase in net deficiency between the relevant dates); and
 - various specific "**individual misfeasance**" transactions which breached various statutory directors' duties, in an aggregate amount of £5.6 million.
- ▶ This case is a rare example of insolvency practitioners successfully holding directors liable for "insolvency-deepening activity" – in this case, against the backdrop of a shareholder "[using] its ownership... to extract as much cash as possible over the short period of its ownership".
- ▶ This case vividly illustrates that the Court:
 - will conduct an extensive analysis of directors' correspondence, including emails, board minutes, handwritten notes of meetings and text messages – some of which may make for uncomfortable reading;
 - may find that taking and relying upon legal advice is not sufficient to protect directors: it is the duty of the directors themselves, and not advisors, to decide whether there is a reasonable prospect of avoiding insolvent liquidation; and
 - may give less weight to minutes prepared in advance by lawyers to approve a particular transaction (and in contrast, may prefer to rely on minutes that are clearly intended to be contemporaneous record).
- ▶ The judgment underlines the critical importance of directors actively considering whether particular transactions are likely to promote the success of each company to which they are appointed, including taking account of creditors' interests in the "zone of insolvency".
- ▶ It is possible that the judgment may be appealed.

Background

This is a high-level summary of a very complex factual background.

MARCH 2015	RAL acquired the loss-making BHS Group for £1 in March 2015 (from a company owned by Sir Philip Green); new directors appointed Terms included an option for the sale of a property, North West House , at £8 million less than the valuation produced in the due diligence exercise
MAY/JUNE 2015	Per the Court's findings: <ul style="list-style-type: none">▶ Directors knew that if the Group did not enter into a new financing (the Loan Note Transaction) immediately then it would be unable to cover rent cheques; this financing was on onerous terms▶ Directors knew that there was no reasonable prospect of achieving the restoration of trade credit insurance (which had been withdrawn in February/March) in the short term▶ Directors ought to have known it was more probable than not that the Group would enter insolvent administration; accordingly, they owed a duty to consider creditors' interests <p><i>Directors' liability for failure to have regard to creditors' interests arose from this date – even though the companies were not yet cash flow or balance sheet insolvent and insolvency was not inevitable</i></p>
SEPTEMBER 2015	Companies were cashflow insolvent (the Court found) and directors knew, or ought to have known, that the companies had no reasonable prospect of avoiding insolvent liquidation or administration <i>Directors' liability for wrongful trading arose from this date</i>
MARCH 2016	Creditors approved a company voluntary arrangement, compromising leasehold obligations
APRIL 2016	Four BHS companies entered administration (as efforts to find financing required pursuant to the CVA had been unsuccessful)
NOVEMBER 2016	Pensions Regulator issued warning notices to various parties, including RAL and the Group's former owner
FEBRUARY 2017	Pensions Regulator entered settlement agreement with all relevant parties (other than Dominic Chappell) to stop the regulatory action
JANUARY 2018	Dominic Chappell convicted of an offence under the Pensions Act for refusing to provide information; contribution notice issued for c.£10 million
OCTOBER 2019	Dominic Chappell disqualified as a director for 10 years
NOVEMBER 2020	Dominic Chappell sentenced to custodial sentence for tax offences in respect of sums extracted from the Group
DECEMBER 2020	Joint liquidators commenced proceedings against certain former directors (the subject of this judgment) for misfeasance (including breach of directors' duties) and wrongful trading, under s.212 and s.214 of the Insolvency Act 1986 respectively

Liquidators' claims

The liquidators alleged that from the date of RAL's acquisition of the Group, and the directors' appointment, the directors either knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration (the **Knowledge Condition**).

This allegation formed the basis for the wrongful trading claim and also formed the factual basis for a "misfeasant trading" claim: the liquidators alleged that even if the relevant directors were not liable for wrongful trading, they failed to consider the interests of the creditors and, if they had done so, they would have immediately filed for administration.

The liquidators also made nine individual misfeasance claims in relation to specific transactions.

Judgment: Wrongful Trading

The Court held as follows.

BACKGROUND

- ▶ The Court may hold directors (or former directors) liable for wrongful trading under the Insolvency Act 1986 (s.214) if the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid insolvent liquidation or administration, unless from that date the director took every step with a view to minimising potential losses to the company's creditors.

KNOWLEDGE CONDITION

- ▶ The liquidators identified six different "knowledge dates" on which they alleged the directors knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid insolvent liquidation or administration. The Court ultimately accepted the last of these dates (September 2015).
- ▶ The liquidators needed to demonstrate that the directors knew or ought to have known that insolvent liquidation or administration was inevitable; however, "blind optimism or micawberism is not sufficient to defeat liability".
- ▶ There is no requirement that the company enter into liquidation or administration within a short period of time: "it would create a real difficulty if the Court laid down a time limit or bracket even as a rule of thumb"; the Court saw "no reason why [directors] should escape liability for wrongful trading on the basis that they were unable to predict precisely when they would have to put the Companies into administration or wind them up". However, the lapse of time between the "knowledge date" and the decision to enter administration is an important evidential factor.
- ▶ **On the facts:** the liquidators succeeded in proving that:
 - the directors knew that the Group's business was loss-making and had been for some time and that RAL had no means of replicating the financial support to the Group that had been provided by its former owner and did not have any financial resources; and
 - by September 2015, the directors knew or ought to have known that the companies had no reasonable prospect of avoiding insolvent liquidation or administration.

STANDARD EXPECTED OF DIRECTORS

- ▶ *Background:* The wrongful trading legislation imposes a minimum objective standard of the general knowledge, skill and experience reasonably expected of a person carrying out the particular director's functions. If the individual's actual knowledge, skill and experience is higher than that of a reasonably diligent person, they will be held to the higher standard. Conversely, if lower, it is no defence that they did not have that knowledge, skill or experience.
- ▶ **On the facts:** the Group's General Counsel did not have the general knowledge, skill or experience that could reasonably be expected of the General Counsel of a group of companies of the size and complexity of the BHS Group. Nor were the other director's functions limited to particular functions, as the director had argued.

Judgment: Wrongful Trading (cont.)

DELEGATION

- ▶ It was not open to a particular director to leave board decisions up to his fellow directors, even where it (arguably) had been agreed that the director's responsibilities would be limited to certain specific areas.

PROFESSIONAL ADVICE

- ▶ Where directors relied on the advice of reputable professionals, they will *prima facie* have fulfilled their duties. However, the weight which the Court will attach to the professional advice which directors take will depend on the scope of the engagement, the instructions which the adviser was given, the knowledge which they had or the assumptions which they were asked to make, the advice which they gave (or did not give) and the extent to which the directors relied on that advice (or not).
- ▶ Where a professional adviser did not advise the board of directors that they should put the group into administration or liquidation, the weight to be attributed to the absence of that advice will depend on a detailed assessment of the facts.

DEFENCE

- ▶ The statutory defence to wrongful trading – that directors took every step with a view to minimising the potential losses to creditors – imposes a high hurdle to overcome.
- ▶ A director may be able to rely on the statutory defence even if they do not take insolvency advice or consider whether to put the company into insolvency proceedings immediately. However, if the director does not do so, it will be more difficult for the directors to demonstrate that they properly considered whether continuing to trade would reduce the deficiency and what the risks were to individual creditors (and, in the present case, the risk to unsecured creditors).

CAUSATION

- ▶ It was common ground between the parties that it was necessary for the liquidators to prove causation i.e. there must be a causal connection between the relevant wrongful conduct and the losses suffered by the company. However, it was not necessary that the directors' conduct be the sole or effective cause of such losses. The question was whether the directors' conduct caused the companies to continue trading and that they would have ceased trading (and entered administration) if the directors had complied with their duties.
 - ▶ The appropriate counterfactual was to consider what would have happened if the relevant directors on trial had complied with their duties. (In doing so, the Court was not required to assume that other directors – in particular, Dominic Chappell – would also have done so.)
 - ▶ **On the facts:** if the relevant directors had concluded (as they should have done) in September 2015 that the companies had no real prospect of avoiding insolvency, then the companies would have gone into administration.
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Judgment: Wrongful Trading (cont.)

QUANTUM OF LIABILITY

- ▶ The Court has a statutory discretion to declare that a director is liable to make such contribution (if any) to the company's assets as it considers proper.
- ▶ The maximum liability of a director for wrongful trading is the increase in the net deficiency in the assets generated by continuing to trade from (a) the date on which the Knowledge Condition is satisfied until (b) the date on which the company goes into insolvent administration or liquidation. (This is because it is the continuing trading in that period which causes loss to the company's creditors.)
- ▶ The Court has a discretion whether to impose liability on directors individually (severally) or collectively (jointly and severally).
- ▶ In doing so, the Court is entitled to take into account the culpability of the director, the extent to which the director's conduct caused the increase in net deficiency, the organisational responsibility of the director, their place in the hierarchy of decision-making and non-causative matters such as means and the scope of their insurance cover. The weight the Court gives to each factor is also a matter of discretion.
- ▶ **On the facts:**
 - The increase in net deficiency between the date on which the Knowledge Condition was satisfied and the date on which the companies filed for administration was £45 million; this was both the starting point and the upper limit for any contribution.
 - It was inappropriate to hold the directors equally liable (on a joint and several basis) given their differing levels of involvement and culpability. The Court evaluated their conduct and fixed individual percentages for each director's liability. Each of the two directors on trial was liable to make a several contribution to the companies' assets of £6.5 million (i.e. total £13 million), with other directors (including Dominic Chappell) potentially liable for the remainder.
 - The Court declined to exercise its discretion to reduce directors' liability on the basis that the Group's D&O insurance (capped at £20 million, including defence costs) would not cover the full claims against them: "to do so would be to send the wrong message to risk-taking directors that they could escape liability if they did not obtain adequate cover to indemnify themselves against wrongful trading".
 - Although the Court accepted that the General Counsel did not receive substantial rewards from his role, and that an award of compensation for wrongful trading would be potentially ruinous for him, it was not persuaded it was appropriate to take these matters into account. "It will send a green-light to risk-taking or, even, dishonest directors if the Court reduces the amount of compensation for which [the General Counsel] is liable on the basis of his ability to pay."

Judgment: Misfeasance / Breach of Directors' Duties

The Court held as follows.

SCOPE AND BREACH OF DUTIES

- ▶ **Background:** The Insolvency Act 1986 (s.212) provides a procedure for the recovery of property or compensation by a liquidator against directors for misfeasance or breach of any fiduciary or other duty. As noted, the liquidators' claim under this section was a novel claim.
- ▶ **"Proper purpose":** s.171 Companies Act 2006 (CA) provides that a director of a company must (a) act in accordance with the company's constitution and (b) only exercise powers for the purposes for which they are conferred.
 - Held: A director who enters into a transaction knowing that it has not been authorised by the board will breach (a) above (unless the transaction is ratified); however, the failure to call a meeting or to minute a decision properly is not of itself a breach of this duty. A director can breach (b) above even if they do not receive a personal benefit.
 - **On the facts:**
 - ▶ directors agreed to the Loan Note Transaction in breach of (b) and for improper purposes; the directors had no real regard to the Group's interests in agreeing to the expensive transaction; and
 - ▶ the sale of North West House at an undervalue was not for a proper purpose; the primary purpose was to further the shareholder's interest and to obtain a loan to fund a capital injection to the Group and release funds to pay RAL's costs of the acquisition. The release of the sale proceeds to RAL was also improper.
- ▶ **Duty to promote success of the company:** s.172 CA imposes a duty on directors to act in a way they consider, in good faith, would be most likely to promote the success of the company. When a company is "insolvent or bordering on insolvency", or an insolvent liquidation or administration is probable, this duty should be understood as including the interests of its creditors as a whole; see our [Alert](#).)
- ▶ *Held:*
 - The board did not actually consider the risks to unsecured creditors or individual creditors of continuing trading – even if there was a reasonable prospect of reducing the net deficiency by continuing to trade over Black Friday and Christmas 2015. Had the board considered this issue, directors would have appreciated that certain creditors would be paid at the expense of the unsecured creditors, by virtue of continuing trading.
 - Had the board considered their duty to creditors (from June 2015 onwards), they ought to have concluded that (a) creditors' interests were paramount (or at least should carry more weight than the interests of RAL, as shareholder) and (b) it was in creditors' interests to put the companies into administration immediately.
 - Entry into the Loan Note Transaction also breached this duty.
 - The sale of North West House (and the onward release of proceeds to RAL) also breached this duty; the directors did not act in good faith and knew it was not in the company's interests to sell the property at an undervalue; no honest or reasonable director would have believed in good faith that it was in the company's interests to pay RAL's costs of the acquisition in the absence of a contractual obligation to do so.

Judgment: Misfeasance / Breach of Directors' Duties (cont.)

SCOPE AND BREACH OF DUTIES (CONT.)

- ▶ **Duty to exercise independent judgment:** s.173 CA requires a director to exercise independent judgment; a director may not defer to the wishes of a shareholder, another director or another person without bringing their own independent judgment to bear on the issue.
- ▶ *Held:* A director failed to exercise independent judgment, including on the sale of North West House. The fact that the director considered it outside his role did not excuse this. "If he had exercised independent judgment, he would have spoken up against the transaction [at the board meeting] and refused to sign the resolution."
- ▶ **Duty to exercise reasonable care:** s.174 CA imposes a duty on directors to exercise reasonable care, skill and diligence.
- ▶ *Held:* Multiple breaches of this standard included:
 - the directors' failure to inform themselves fully about the Group's pension deficit;
 - the General Counsel's failure to call a board meeting to consider entry into the Loan Note Transaction and record the reasons why the board considered it to be in the interests of each of the companies and its creditors;
 - a director's failure to attend certain board meetings without explanation;
 - a director's authorisation of the sale of North West House without ascertaining whether it was being conducted at true market value; and
 - a director's decision to agree to pay certain amounts (including to RAL) without the relevant company being liable to do so and without satisfying himself that it was appropriate for the payments to be made given the Group's financial condition.
- ▶ **Duty to avoid unauthorised conflicts:** s.175 CA imposes a duty on directors to avoid unauthorised conflicts of interest.
- ▶ *Held:* A director breached this duty, including in failing to avoid a situation in which he had a direct conflict with a company's interests in relation to the exploitation of one of the company's major assets (i.e. as director of both RAL and the company which sold North West House). The director should not have accepted appointment as director of the latter.
- ▶ **Duty not to accept benefits:** s.176 CA provides that a director must not accept a benefit from a third party conferred by doing (or not doing) anything as director, if the benefit is likely to give rise to a conflict of interest.
- ▶ *Held:* A director breached this duty by accepting a secret commission from a third party for agreeing the sale of North West House.

Judgment: Misfeasance / Breach of Directors' Duties (cont.)

RELIEF FROM LIABILITY

- ▶ The Court may relieve a director from liability for breach of duty (s.1157 CA).
- ▶ However, the Court dismissed the relevant directors' applications for relief, as they failed to satisfy the Court that they acted reasonably or that it would be fair in all the circumstances to excuse them from liability.

QUANTUM OF LIABILITY

- ▶ The Court reserved judgment as to the appropriate quantum of damages for the misfeasant trading claim, pending further argument.
 - ▶ The Court ordered the relevant directors be liable in respect of various "individual misfeasance" transactions, in an aggregate amount of £5.6 million.
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