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BHS: DIRECTORS HELD PERSONALLY LIABLE FOR WRONGFUL TRADING AND BREACH OF DUTY

Much ink has already been spilled over the recent English case initiated against the former directors of four companies in the British Home Stores Group (BHS). The group collapsed into insolvency over 8 years ago, leaving creditors seriously out of pocket to the tune of £1.3bn and with the pension funds alone having a £571m shortfall at the time of the collapse.

The collapse of BHS also prompted criminal sanctions against one of the directors, a disqualification order, and select committee enquiries, which resulted in changes to the pensions legislation to deter poor behaviour. In this latest case, other directors were held to be personally liable for over £42m (this included a notional liability in respect of two directors who had already reached a settlement and did not participate in the trial), with further damages to be assessed at a later date for misfeasance, which could be as much as £133.5m. In this short note we set out the key issues and practical lessons from the case, starting with our initial reactions to the Court's decision.

Philip Hertz, Global Head of the Restructuring and Insolvency team, comments, "*Wrongful trading cases are notoriously difficult to bring, so the fact that this case has been successful is significant in itself. The scale of the personal liabilities is also something that has attracted the headlines. As advisers we recognise the challenges that directors might encounter in distressed situations and the tough choices that have to be made, often in time pressured circumstances. This case recognises the importance of getting timely advice to ensure that directors are in a position to understand the implications of their actions, from a legal and financial position. It's not always easy but directors need to ensure that they properly evidence their considerations and are able to justify the steps and decisions taken. As I often comment in these difficult situations, directors may be wrong as long as they do not act unreasonably and the taking of advice is usually a hallmark of reasonable action* ".

Melissa Coakley, partner in the Restructuring and Insolvency team, also comments, "*This case has taken place under the media spotlight, so it is not surprising that the directors became the focus of claims by the liquidators seeking to recover as much as possible on behalf of the creditors. It is very clear from the detailed judgment and the forensic approach to the contemporaneous evidence that for it to reject such claims, the Court needs to see that the directors can demonstrate that they have acted with reasonable care, skill and diligence. That means seeking advice and ensuring that their*

Key issues

- Directors held personally liable for wrongful trading and breach of duties in BHS collapse.
- The award is the highest to date for a wrongful trading claim and further liabilities for breach of duties are yet to be assessed.
- Liability will not be capped at the level of D&O cover or the amount the directors can afford.
- This case is fact specific, but serves as a reminder that:
  - companies in distress need to seek and then follow advice from financial and legal advisers – ultimately directors have the responsibility to make decisions;
  - directors need to demonstrate and evidence that they have exercised reasonable care, skill and diligence;
  - the duty to promote the success of the company includes a duty to act in the interests of creditors when insolvency becomes inevitable; and
  - acting honestly does not relieve directors of their duty to act competently.

advisers have all the necessary information to assist and provide proper guidance. As the Court in this case finds, directors who do not take insolvency advice – and demonstrably follow it – or consider whether insolvency proceedings should be commenced, will find it more difficult to demonstrate that they properly considered whether continuing to trade would reduce the deficiency to creditors and risks to them. Most directors of companies facing financial difficulties will find themselves in unknown territory and be confronted with many decisions that are not easy and that is where the need for specialist advice comes in. Knowing when to seek assistance, and being aware of their duties is paramount, but, as this case demonstrates, directors also need to be able to show that they have acted upon that advice, and not simply approached the advice as a necessary 'tick-box' exercise".

Nigel Wellings, Joint Head of the Corporate team, notes, "*This case serves as a reminder that significant personal liability can be imposed if a director breaches their duties and fails to prioritise creditors' interests when insolvency has become inevitable. When situations arise outside the scope of ordinary commercial operations directors may need to take early specialist advice so they can properly assess duties*".

Tim Lees, partner in our Restructuring and Insolvency team, adds: "*Identifying when creditors' interests become paramount is not straightforward. This case considered a number of different points in time. The liquidators alleged that from the outset of the purchase of the business for £1, the directors knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation. The court rejected this and a number of other earlier dates proposed by the liquidators, but found that by 8 September 2015 the directors should have known that there were no longer reasonable prospects of avoiding insolvent liquidation or administration and could therefore be liable for wrongful trading. Interestingly, the court chose an earlier date of 26 June 2015 in relation to liability for the breach of creditor duty claims. The companies went into formal insolvency processes in April 2016. This in itself illustrates that the point in time where there may be a shift in duty is not easy to identify, even with the benefit of hindsight. Careful assessment is required which underlines the importance of having up to date financial data, meeting regularly to consider it, and keeping proper records of what was considered*".

Practical lessons

- Directors should ensure adequate and effective internal controls are in place to monitor the financial position of the company and promptly take action if issues are identified.
- Directors need to be actively engaged in and then document their decision making, including attendance at meetings which consider the financial performance, strategy and risks.
- Directors should obtain legal advice as to what their duties are and how they might best discharge them in the relevant circumstances. They should also be mindful of their obligation to consider the interests of creditors as a whole where the viability of the company is or could be at risk.
- Specialist insolvency advice (financial and legal) will be necessary to help directors determine whether the company is likely to become insolvent, so they can determine what action to take.
- If the company is insolvent or is likely to become insolvent, directors will need to take separate legal advice on whether their proposed course of

action might also expose them to personal liability for wrongful trading or misfeasance under the Insolvency Act 1986.

Background

One director, Dominic Chappell, has already been subject to criminal sanctions for tax evasion and is disqualified from acting as a director. This latest decision is as a result of a civil claim brought by the liquidators which holds other directors responsible for wrongful trading and breach of duty. Mr Chappell was also subject to these proceedings, but, due to his ill health and inability to participate in these Court hearings, a separate hearing to determine his liability will be held at a later date. **Helen Carty**, partner in our Litigation and Dispute Resolution team, comments "*It is highly unusual to sever claims in this way, but it was based upon the fact that Mr Chappell was unable to participate and had applied for an adjournment in relation to the claims against himself, but not the remainder of the trial itself. The judgment is clear that although findings may have been made about Mr Chappell's conduct, they are not binding upon him and he will have an opportunity to respond at a later point in time*". Despite this, Mr Chappell was heavily criticised during this hearing and found to be dishonest and largely responsible for the collapse. Some market commentators consider that BHS was doomed to failure from the start when he purchased BHS for £1 without having any sustainable working capital facility. The strategy he adopted was referred to as 'deepening insolvency' and essentially involved taking on expensive finance to keep the business going and pursuing a disposal of assets (in certain cases at an undervalue), all the while trying to resolve the huge pension deficit, without success.

Key aspects of the claim

The liquidators were successful against the former directors of BHS for wrongful trading and breaches of their directors' duties – so called 'misfeasance' or breaches of the Creditor/'Sequana duty'. The misfeasance damages are to be assessed at a later date. (For a brief reminder of the directors' duties, wrongful trading and misfeasance see the boxes below. For more analysis on the Duty to Creditors see our Sequana briefing).

While fact specific, this case is a good reminder for directors of the potential personal liabilities they risk for getting things wrong in circumstances where decisions are not found to be reasonably made and, importantly, not in line with professional advice.

What did they get wrong in this case?

Breaches of duty: The list of breaches of directors' duties is long. It includes failing to promote the success of the relevant company; failing to exercise independent judgement; failing to exercise reasonable care, skill and diligence; and failing to avoid conflicts (including making secret commission or acting only in the interests of shareholders at a time when the interests of creditors ought to have been considered). In some instances, the directors didn't follow any proper process at all in their decision making; in other situations, they followed the correct procedure and sought advice, but failed to follow it, or ignored it. In other instances, they also failed to provide their advisers with complete or adequate information to ensure that the advisers were in a position to properly advise. The judge considered much of the written evidence, in particular the board minutes, to be formulaic, and, based upon other evidence heard by the Court, it was clear that in many instances there were no genuine discussions regarding the potential risks and

consequences of the directors' actions, including, crucially, whether they were to the detriment of the company's creditors.

The Court found the directors to be lacking in competence. The General Counsel, for example, was held to be out of his depth and without a clear appreciation of the commercial setting within which he was acting.

Honesty is no defence: This case is also a reminder that acting honestly will not be enough. Directors must also act reasonably and with due skill and attention. It was noted, with some sympathy by the judge, that while one of the directors had behaved honestly and 'tried his best', his good intentions were insufficient to relieve him of liability.

Wrongful trading: The directors failed to act upon the evidence that the relevant companies were insolvent, they did not take appropriate action in light of the companies' deteriorating financial position and, at a time when a formal insolvency became inevitable, they failed in their duty to act in the best interests of creditors by failing to take action to minimise risks.

While the directors sought professional advice in this case, including on the risks of insolvency, the judge reminds us that this does not mean directors can relinquish all responsibility – they must still be the ones making the decisions, seeking appropriate advice and acting upon it. The directors also failed to provide their advisers with accurate and complete information to enable the advisers to properly assist. The judge held that the directors sought advice as a 'box ticking exercise' and they should have known that insolvency was imminent.

Liability not limited by reference to D&O cover

Interestingly, the directors argued that their liabilities should be capped at the level of the D&O policy and reflect their means to pay, rather than being based on the increase in the net deficiency of assets arising from the time they ought to have prioritised creditors' interests to the date of the insolvency, which was caused by their breaches of duty and continuation of trade. Neither argument was accepted as the judge was concerned that this would send out the 'wrong message' in relation to directors and their responsibilities. **Chris Ingham**, partner in our Insurance team, notes, "*It is unsurprising that the judge did not limit the liability in line with the cap in the D&O policy. In fact, following the hearing it was reported that the cap was inclusive of costs, so the liquidators' actual recovery may ultimately be further reduced. The case demonstrates the importance of directors ensuring that they have adequate D&O cover in place that reflects the nature and quantum of potential liabilities that they might be exposed to*".

Conclusions

While this case is perhaps an extreme and fact specific example of what can go wrong if directors do not exercise their responsibilities properly and fail to take appropriate advice and then act accordingly, it serves as a useful reminder of the responsibilities applicable to directors.

Given the sums at stake and the unusual approach to splitting the hearing, this decision may be likely to be subject to an appeal.

Directors' duties under the Companies Act 2006 (relevant to this case)

All directors owe certain legal and fiduciary duties to their company. The duties and responsibilities of directors are personal and cannot be

delegated, and although management functions may be delegated, it remains their duty to monitor and supervise the discharge of those functions.

As codified in the Companies Act 2006, these include duties:

- to act within powers (section 171)
- to act in a way that a director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole…having regard to a non-exhaustive list of other considerations and subject in certain circumstances to considering or acting in the interests of the creditors (section 172)
- to exercise independent judgement (section 173)
- to exercise reasonable* care, skill and diligence (section 174)
- to avoid conflicts of interest (section 175)
- not to accept benefits from third parties (section 176)

*What is "reasonable" will be determined by reference both to the standard that could reasonably be expected of a person carrying out that director's function; and to the general knowledge, skill or experience possessed by that director which might subject that director to a higher duty of care.

Wrongful trading

Where an insolvent liquidation or administration is inevitable, the creditors' interests become paramount as the shareholders cease to retain any valuable interest in the company, and the wrongful trading provisions under section 214 of the Insolvency Act 1986 are engaged.

A director may face personal liability for wrongful trading where:

a. the director knew (or ought to have known) that there was no reasonable prospect of the company avoiding an insolvent liquidation or administration; and

b. the director fails to take every step to minimise potential loss to the company's creditors that they ought to have taken.

Misfeasance

A summary remedy under section 212 of the insolvency Act 1986 allows a liquidator to bring claims against officers when they have misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.

More insights

If you would like more insights on issues facing boards and their legal team take a look at our Across the Board insights designed to help you support your organisation's strategic business priorities, mitigate legal and business risk and guide Board members through complex Boardroom issues.

For directors facing financial difficulties and how their duties may differ in different jurisdictions across the globe, why not take a look at our high level Debt Restructuring Guide.

If you are interested in discussing any of the issues raised in this briefing, we would be delighted to discuss them further with you. Please get in touch with your usual Clifford Chance contact, or any of the contacts listed in this briefing.

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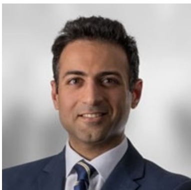

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