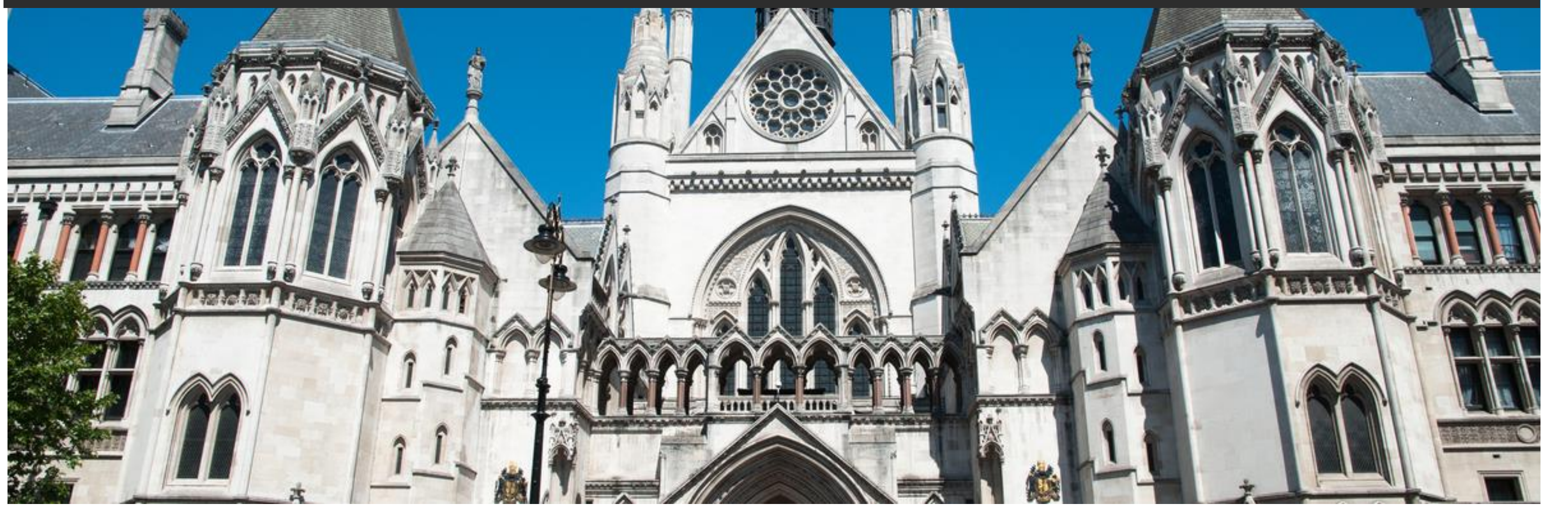
Alert | Restructuring & Bankruptcy



June 2024

English Courts Introduce Novel Concept of 'Trading Misfeasance'

On 11 June 2024, Mr. Justice Leech handed down a landmark UK judgment relating to wrongful trading and misfeasance against the former directors of the BHS Group of companies (BHS) pursuant to the Insolvency Act 1986 (IA86).

The 533-page judgment saw one of the largest reported wrongful trading awards since the introduction of IA86, as well as a novel claim for "misfeasant trading."

A hearing to determine overall quantum will be heard in June.

Key Takeaways

- Highlights that the insolvency practitioner seeking to bring a wrongful trading claim must be able to identify the "knowledge date."
  - This is the date on which the directors knew or ought to have known there was no reasonable prospect of the company avoiding insolvency.
  - The case also confirms that it is permissible for the liquidators to submit multiple "knowledge dates" – in this case the liquidators put forward six such dates.

- Confirms that the relevant period for which the directors can be personally liable for wrongful trading is the date from which the "knowledge condition" is satisfied to the date on which the company enters insolvency proceedings.
- Suggests that the court will focus on the increase in net deficiency (IND) in the assets caused by the company continuing to trade past the knowledge date.
- Demonstrates that a separate "trading misfeasance" claim can be brought by insolvency practitioners, and the facts supporting that claim may pre-date the knowledge date for wrongful trading purposes.

Background

Retail Acquisitions Limited (RAL), owned by BHS director Dominic Chappell, acquired BHS, owned by Sir Phillip Green's company Arcadia, on March 12, 2015, for a nominal sum of £1. BHS collapsed just a year later with significant liabilities, including a c.£571m pension deficit.

The joint liquidators at FRP Advisory brought claims for wrongful trading and misfeasance from the date of the RAL acquisition against former directors Lennart Henningson, Dominic Chandler, and Dominic Chappell. Following his recent release from prison for tax evasion, Mr. Chappell was not bound by the ruling, and a further trial will determine his liability.

Outcome

1. The applicants claimed £160m in total quantum against the former directors. Of the four, Keith Smith settled the joint liquidators' claims ahead of the trial and as mentioned above, the judgment was not binding on Mr. Chappell.

2. The joint liquidators brought three categories of claim, referred to in the judgment as the "Wrongful Trading Claim," the "Trading Misfeasance Claims," and the "Individual Misfeasance Claims."

Wrongful Trading Claim

3. With regard to the Wrongful Trading Claim, the joint liquidators put forward six "knowledge dates," of which they alleged the directors had requisite knowledge to violate the relevant knowledge provisions under s.214 IA86. The earliest of those dates was one month following the date of the acquisition by RAL and the latest being a date just under six months post-acquisition.

4. The only knowledge date that the court found satisfied the provisions of s.214 IA86 (i.e., that the directors knew or ought to have known there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration) was the final date, 8 September 2015.

5. The court concluded that the directors met the provisions of s.214 IA86 by 8 September 2015, notwithstanding that BHS had sought advice from reputable external advisors, and by that date none of those advisers had determined there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration. The court attached little weight to the professional advice given at the time, as, amongst other reasons, the directors did not rely on the advice, instead generally favouring the interests of Mr. Chappell and RAL.

6. The maximum quantum for which the court could declare the directors liable was the IND to the estate (i.e., the increase in the company's debts or the reduction in its assets) from the time when they first had this knowledge, being 8 September 2015.

7. The court has a limited discretion whether to impose joint and several or several liability where there are multiple directors. The court can consider the culpability of each director, the extent to which their conduct caused the net deficiency, the organisational responsibility, their place in the hierarchy of decision-making, and other factors such as the scope of their insurance cover. Ultimately, the court held both directors liable on a several basis in the sum of £6.5m (despite the IND from 8 September 2015, being agreed as £45.5m).

Individual Misfeasance Claims

8. The joint liquidators put forward that one or more of the directors breached their statutory duties (pursuant to sections 171-177 Companies Act 2006) in eight individual transactions concerning individual assets or funds. This contrasts with the Trading Misfeasance Claims, which alleged the directors failed to consider their statutory duties and had they done so properly, they would have concluded that BHS should not have continued trading.

9. Four of the eight Individual Misfeasance claims failed for lack of causation. For those transactions, the court found that Mr. Chappell was the dominant director and the principal actor, and that even if the directors had acted in accordance with their duties, Mr. Chappell would have engineered the removal of those directors and procured BHS to enter into those transactions in any event. In respect of the four successful claims, the directors were found liable for an aggregate sum of £5.6m.

Trading Misfeasance Claims

10. With regard to the Trading Misfeasance Claims, the joint liquidators argued that the directors committed breaches of their fiduciary duties in continuing to trade and enter into certain finance transactions. As mentioned above, this is a novel claim, and the court held that the directors failed to consider the interests of the creditors in the entry of two separate funding agreements, and that if they had complied with those duties, then BHS would not have continued to trade and would have gone into insolvent administration.

11. Interestingly the knowledge date at the time of the entry into the first finance transaction was 26 June 2015, a date which the judge decided (in respect of the Wrongful Trading Claim) that insolvent liquidation or administration was not inevitable. In other words, the Trading Misfeasance Claim arose in June 2015, before the knowledge date for wrongful trading occurred on 8 September 2015.

Key Takeaways

The successful application of trading misfeasance offers an additional tool to an office holder's toolkit. It was only last year where the Supreme Court held in *BTI 2014 LLC v Sequana SA* [2022] UKSC 25 that "there may be more egregious circumstances in which the absence of a remedy beyond section 214 [wrongful trading] would appear to be a lacuna in our law." Trading misfeasance appears to fill that lacuna.

Although a certain overlap between this concept and wrongful trading remains, trading misfeasance allows the office holder to put forward claims that the directors were acting in breach of their duties by continuing to trade the business and bypass the requirement that the director(s) knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration.

With regards to the Wrongful Trading Claim, it should be noted that the court declined to exercise its discretion to reduce the directors' liability despite BHS's D&O insurance policy being insufficient to cover the full claims brought against the directors. The court held that "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." The court also refused to exercise its discretion notwithstanding the ability of Mr. Chandler to pay the sums he was found liable for, again, stating that it "sends a green light to risk-taking or, even, dishonest directors…"

Interestingly, the judge did not determine the appropriate level of compensation in respect of the Trading Misfeasance Claims. While it may not be appropriate for the directors to be liable for the entire increase in the net deficiency from the date the company entered into the relevant transaction, this should be quantified by the loss those transactions caused, otherwise it may allow office holders to bypass the stringent knowledge test required for a successful wrongful trading claim.

Authors

This GT Alert was prepared by:

- John Houghton | +44 (0) 203.349.8777 | John.Houghton@gtlaw.com
- Rupert Cheetham | +44 (0) 203.349.8735 | Rupert.Cheetham@gtlaw.com
- Nazmul Miah | +44 (0) 203.349.8700 | Nazmul.Miah@gtlaw.com