<u>Directors' Duties in Insolvency: The BHS Case and Its Implications for Corporate Governance</u>

By Eugenio Vaccari

Directors' Duties in Insolvency under English Law

Under English law, directors of a company owe a set of duties primarily to the company itself. However, when a company approaches or enters insolvency, the focus of these duties shifts from the shareholders to the creditors. This shift in responsibility is crucial because creditors' interests become paramount as the financial stability of the company deteriorates. The case law surrounding directors' duties in insolvency is both complex and evolving, with significant recent developments shaping the landscape.

One of the landmark cases in this area is *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, where the Supreme Court examined the circumstances under which directors must consider the interests of creditors. In this case, the directors of AWA had declared a dividend at a time when the company was solvent but facing contingent liabilities that could result in future insolvency. The Court held that directors are required to consider creditors' interests only when they know, or should know, that the company is either insolvent or is bordering on insolvency. The ruling established that a mere real risk of future insolvency is insufficient to trigger this duty; insolvency must be either imminent or inevitable.

This precedent has had a profound impact on subsequent cases, including the recent decision in *Re BHS Group Ltd & Ors (in liquidation) [2024] EWHC 1417 (Ch)*, where the High Court further explored the extent and nature of directors' duties during the period leading up to a company's insolvency.[1] The BHS case is particularly notable for its large-scale wrongful trading and misfeasance claims, illustrating the significant personal liabilities that directors can face when they fail to appropriately consider creditors' interests.

The BHS Judgment: A Landmark in Directors' Liability

The judgment in *Re BHS Group* is a significant development in the enforcement of directors' duties during insolvency. BHS, once a major player in the UK retail sector, collapsed into administration in 2016, leading to its eventual liquidation. The case involved claims brought by the liquidators against two former directors of BHS for wrongful trading and misfeasance, resulting in one of the largest-ever awards for wrongful trading and the first-ever recognised claim of misfeasance trading.

BHS was sold for £1 in March 2015 to Retail Acquisitions Limited (RAL), a company controlled by Dominic Chappell, a businessman with no prior experience in retail and a history of bankruptcy. Despite assurances that RAL would inject £5 million into BHS, no such funding materialised. By mid-2015, the financial situation of BHS had deteriorated significantly. The directors were aware that the company would require new financing to continue its operations, and that there was little to no prospect of restoring trade credit insurance, which had been withdrawn earlier that year.

Despite these warning signs, the directors continued to trade, entering into a loan agreement with exorbitant interest rates—referred to in the judgment as a "Wonga" loan. The High Court found that

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[1] For a comprehensive analysis of this case, see (among others): K Stephenson, 'English Court imposes multi-million pound liability on former directors of BHS for breach of directors' duties and wrongful trading' (2024) 21(4) Int. C.R. 206.

by June 2015, BHS's directors should have realised that insolvency was more than just a possibility; it was probable. Their failure to consider the interests of creditors at this stage, and their decision to continue trading and incurring further liabilities, constituted a breach of their fiduciary duties under s. 172(3) of the Companies Act 2006.

Wrongful Trading and Misfeasance: The Legal Framework and Findings

The claims of wrongful trading were brought under s. 214 of the Insolvency Act 1986, which holds directors accountable if they continue to trade when they know, or ought to know, that there is no reasonable prospect of avoiding insolvent liquidation or administration. The liquidators successfully argued that from September 2015, the directors knew or should have known that BHS had no reasonable prospect of avoiding insolvency. The High Court ruled that this marked the point at which the directors' liability for wrongful trading began.

The judgment is particularly significant for its treatment of the standard of care expected from directors. The court reaffirmed that directors are held to a minimum objective standard of general knowledge, skill, and experience. However, where a director possesses greater expertise, they are held to a higher standard reflective of their actual abilities. This principle was applied stringently in the case of Mr. Chandler, one of the defendant directors, who was found to have acted incompetently but not dishonestly. Despite this, he was still held liable for a substantial sum due to his failure to take adequate steps to protect the interests of creditors.

The court awarded £6.5 million each to the liquidators for the wrongful trading claims against the two directors, reflecting the £45 million increase in BHS's net deficiency from September 2015 to the date of administration. This ruling highlights the significant personal liabilities that can be imposed on directors for failing to cease trading when insolvency is inevitable.

In addition to wrongful trading, the directors were also found liable for misfeasance under s. 212 of the Insolvency Act 1986. Misfeasance involves a breach of fiduciary duties owed to the company, including the duties to act in the best interests of the company and to avoid conflicts of interest. The court held that the directors had breached these duties by continuing to trade and incur liabilities without considering the creditors' interests, particularly after it became clear that insolvency was unavoidable.

The misfeasance claims were ground-breaking in recognising a novel claim for "misfeasance trading", which refers to the directors' breach of statutory duties by continuing to trade without sufficient regard to creditors' interests. The quantum of liability for these breaches was not determined in the judgment but was noted to potentially reach up to £133.5 million.

Implications of the BHS Judgment

The *Re BHS* judgment has significant implications for directors of companies approaching insolvency. It reinforces the principle that directors must be vigilant in assessing the company's financial position and prioritising creditors' interests when insolvency is on the horizon. The judgment also serves as a warning that reliance on external advice, such as legal opinions, will not shield directors from liability if they fail to exercise independent judgment based on the company's actual circumstances.

Moreover, the case underscores the importance of directors maintaining a high standard of care in their decision-making processes, particularly when a company is in financial distress. The court's willingness to impose substantial personal liabilities on directors, even in the absence of dishonesty, highlights the serious consequences of failing to adhere to these standards.

Finally, the recognition of “misfeasance trading” as a distinct claim opens the door for further developments in the law regarding directors’ duties in insolvency. This new area of liability could lead to more claims against directors who continue to trade despite clear signs of insolvency, potentially resulting in even greater scrutiny of directors’ actions during financially challenging times.

In conclusion, the *Re BHS* judgment serves as a stark reminder of the critical importance of directors' duties in insolvency. Directors must act prudently, prioritising the interests of creditors, and ensuring that their decisions are made with a full understanding of the company’s financial situation. Failure to do so can result in severe personal and financial consequences, as vividly illustrated by the liabilities imposed in this landmark case.

Author:

Dr. Eugenio Vaccari
Senior Lecturer in Law
Royal Holloway, University of London