BHS: what the landmark judgments mean for the directors of distressed businesses

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We examine the findings of the High Court's decisions and discuss the lessons which directors of distressed businesses should take from them

The collapse of BHS in April 2016 remains one of the most extraordinary corporate failures in recent memory. Eight years on from the commencement of insolvency proceedings, and following a lengthy trial, the High Court has issued an expansive judgment on claims brought by the joint liquidators of four companies in the group against two former directors.

Factual background

The facts underpinning the liquidators' claims are complex and the judgment sets these out in a comprehensive chronology spanning 175 pages. The key points to note are as follows:

1. On 11 March 2015, Retail Acquisitions Limited (**RAL**) completed the acquisition of the entire issued share capital of BHS Group Limited (**BHSGL**), the holding company of the BHS group, for £1. BHS was loss-making for several years prior to the sale and had been reliant on financial support from its previous owners.
2. BHS Limited (**BHSL**), the principal operating company of the group, was the sponsoring employer of two defined benefit pension schemes. The due diligence carried out by RAL's advisers in connection with the acquisition highlighted the parlous state of these schemes, noting that that there existed a funding deficit of c. £300m (which was subject to imminent review at an upcoming triennial valuation) and a buyout deficit in excess of £500m.
3. In an effort to address the substantial funding gap caused by ongoing trading losses and RAL's inability to provide meaningful financial support, BHS' new management pursued a strategy of selling certain property assets and obtaining short term and extremely expensive loan funding secured against others.
4. In late 2015, BHS began to explore the viability of launching a property-led company voluntary arrangement (**CVA**). Despite the CVA being approved by creditors on 23 March 2016, all four group companies relevant to this judgment went into administration a month later as efforts to obtain a new asset-based lending facility failed.

Respondents

The liquidators brought claims against three former directors, Dominic Chappell (**Chappell**), Lennart Henningson (**Henningson**) and Dominic Chandler (**Chandler**). Chappell however did not participate in the trial and the claims against him were severed from the claims against Chandler and Henningson. An ex tempore judgment was entered against Chappell and declarations were made which reflected the findings in the judgment.

Chandler and Henningson had contrasting backgrounds and levels of experience when they accepted their appointments shortly after RAL completed the acquisition. Chandler, who was engaged as Group General Counsel, was a criminal barrister by training and had no experience as a corporate lawyer. Henningson on the other hand was a corporate finance professional and experienced turnaround specialist. We return to the significance of this throughout this article.

Claims

The liquidators brought three categories of claim against Chandler and Henningson. These are referred to in the judgment as the Wrongful Trading Claim, the Trading Misfeasance Claim and the Individual Misfeasance Claims.

Wrongful Trading Claim

Law

The Wrongful Trading Claim was founded on section 214 of the Insolvency Act 1986 (**IA 1986**). In order to engage section 214, the liquidators had to establish (among other things) that, at some time before the group companies went into insolvent liquidation, Chandler or Henningson knew or ought to have concluded that there was no reasonable prospect that an insolvent liquidation or insolvent administration would be avoided. If this requirement (the **Knowledge Condition**) was met, the court would have a discretion to declare them liable to make a contribution to the assets of the companies unless it was satisfied that they took every step with a view to minimising the potential loss to the company's creditors as they ought to have taken.

For the purposes of the Knowledge Condition and the "every step" defence, the court must apply a "**Notional Director**" standard. This measures directors against a minimum objective standard of a reasonably diligent person having the general knowledge, skill and experience reasonably expected of a person carrying out that director's functions. If, however, the director's general knowledge, skill and experience is higher than this baseline, they are held to that higher standard.

Pleadings

A significant portion of the judgment is given over to the analysis of if and when the Knowledge Condition was satisfied, due (in part) to the liquidators having pleaded six alternative knowledge dates (**KDs**) on which they alleged that the respondents had the requisite knowledge to fix them with liability under section 214. The first knowledge date (KD1) fell on 17 April 2015, a little over a month after the RAL acquisition completed, and the last (KD6) fell on 8 September 2015.

The complexity of the Knowledge Condition analysis was further compounded by: (a) Henningson and Chappell not giving oral evidence at the trial; (b) the actual knowledge of Chandler and Henningson being materially different, due in part to the nature of their relationships with Chappell; and (c) the Notional Director standard being different for Chandler and Henningson as a result of their experience and functions being different.

Findings

Knowledge Condition

Mr Justice Leech reached the conclusion that the Knowledge Condition was only satisfied on KD6, 8 September 2015. Relying on the Notional Director standard, he noted that at this point in time Chandler and Henningson (among other things):

- Ought to have known that there was no prospect of obtaining a sustainable working capital facility, in light of the extensive discussions held with funders to date.
- Ought to have understood that the property and finance strategy was degenerative and would lead to the group running out of assets to fund its losses long before a turnaround of the business could be achieved.
- Actually knew that the BHSL board did not have a strategy in place to deal with the pension schemes and ought to have understood that it could not afford to pay increased amounts in connection with the schemes once the triennial valuation had taken place.

Respondent submissions – professional advice and the CVA

Counsel for Chandler and Henningson placed reliance on the fact that lawyers acting for the group gave no advice that there was no reasonable prospect of avoiding insolvent administration or liquidation. This submission was rejected. The court accepted that legal advice could provide an evidential basis for dismissing a wrongful trading claim where directors carefully considered and followed that advice but held that this was not the case on these facts. In addition, the group's lawyers could not have been expected to do more than identify the legal issues which the directors had to consider in light of the severity of the financial position; the reasonable prospect assessment was a matter for the individual judgment of the directors.

The respondents also argued that the CVA, and the creditors' approval of it, was a complete answer to the Wrongful Trading Claim as it showed that insolvency was not inevitable. This was also rejected, firstly because the CVA was not in contemplation until some time after KD6 and secondly because it was, in any event, unsuccessful in preventing the companies from going into administration as it did not provide a solution to the funding and pension issues.

"Every step" defence

With the elements of the Wrongful Trading Claim having been made out by the liquidators as at KD6, Chandler and Henningson had the burden of demonstrating that they subsequently took every step to minimise the potential loss to the companies' creditors. They submitted that continuing to trade over Black Friday and the Christmas period was such a step, but this failed after the judge rejected the notion that the BHSGL board believed that the group would trade profitably over that period. Importantly, Mr

Justice Leech was also not satisfied that the BHSGL board had considered the risks of continued trading to unsecured creditors or individual creditors such as the pension trustees, employees or suppliers.

Remedy

The judgment confirms that the court has a broad discretion in wrongful trading claims when determining the level of contribution and is entitled to take all relevant circumstances into account. However, the starting point for assessing liability (and the maximum amount which the court can declare directors liable to contribute) is the increase in the net deficiency in the assets generated by continuing to trade from the date on which the Knowledge Condition is satisfied until the date on which the company goes into insolvent administration or liquidation (referred to as the **IND**).

Between KD6 and the date of the administrations, the IND was agreed to be £45.5m (although the quantum of the claim was reduced to £42m to reflect the settlement of a co-director). Chandler and Henningson were each ordered to make a contribution of £6.5m (roughly 15% of the total) to the companies' assets, on a several liability basis. In the ex tempore judgment, Chappell was ordered to make a contribution of £21.5m to the companies' assets.

Trading Misfeasance Claim

Law

The Trading Misfeasance Claim were founded on section 212 of the IA 1986. Section 212 provides a procedure for the recovery of compensation by a liquidator against an officer of a company, such as in circumstances where they have breached a statutory duty under the Companies Act 2006 (**CA 2006**). The Trading Misfeasance Claim concerned alleged breaches of the duties codified in sections 171, 172 and 174 of the CA 2006 (respectively the duty to act within powers, the duty to promote the success of the company and the duty to exercise reasonable care, skill and diligence).

Where a breach of duty has been established, a director may apply for relief from liability pursuant to section 1157 of the CA 2006. A director who seeks to rely on this section has the burden of proving that they acted honestly and reasonably, and that they ought fairly to be excused having regard to all the circumstances.

Pleadings

The liquidators' case was that Chandler and Henningson committed breaches of the duties in sections 171, 172 and 174 of the CA 2006 by continuing to trade and that, had they discharged their duties properly, they would have sought administration far sooner than they ultimately did. As with the Wrongful Trading Claim, this had to be tested at each of the KDs.

Findings

Breaches of duty

The Trading Misfeasance Claim succeeded in relation to KD3 and KD6, with Mr Justice Leech finding that Chandler and Henningson were in breach of their duties under sections 172 and 174 of the CA 2006 as a result of failings relating to the approval of onerous and expensive short term finance arrangements. Henningson was also found to have breached the duty in section 171 of the CA 2006 at KD3 by agreeing the funding for an improper purpose.

The conclusion relating to the breach of section 172 of the CA 2006 at KD3 is particularly significant and requires further discussion:

- Section 172 expressly provides that the duty to promote the success of the company has effect subject to any rule of law requiring directors to consider or act in the interest of creditors. In the 2022 *Sequana* decision (discussed in this briefing note), the Supreme Court affirmed (inter alia) that when a company is insolvent, at risk of imminent insolvency or when an insolvent liquidation or administration is probable, the duty is modified to include an obligation to consider the interests of creditors.
- Despite having dismissed the Wrongful Trading Claim in relation to KD3, Mr Justice Leech was satisfied that the modified duty to consider the interests of creditors had arisen by that time. At this stage it was more probable than not that the relevant companies would eventually go into insolvent liquidation or administration, but not inevitable (as the wrongful trading test required).
- The judge went on to find that the BHSGL directors had not considered their duty to creditors and had failed to appreciate that the interests of the group's existing creditors were paramount or, at the very least, should carry more weight than the interests of RAL (the sole shareholder). Had they done so, they ought to have resolved to put BHSGL and the other group companies into administration immediately on the basis that the new financing damaged the interests of creditors because of its onerous terms and degenerative effect on the group's assets.
- Adopting language from *Sequana*, incurring the new debt was a last desperate throw of the dice and a good example of insolvency-deepening activity.

Relief

Henningson's request for relief pursuant to section 1157 of the CA 2006 was firmly rejected. He was found to have deliberately misled the court in relation to several matters and to have consistently put the interests of RAL and Chappell ahead of the interests of the companies, their employees and creditors.

The judge was more sympathetic towards Chandler, finding that he had behaved honestly and with the best of intentions, but this was not sufficient to absolve him of liability. Chandler was out of his depth and inexperienced, as evidenced by a lack of commercial acumen and poor decision-making at critical moments. On such occasions, he failed to act with the care and circumspection which could reasonably be expected of General Counsel of the BHS group.

Remedy

Prior to the resumed trial on quantum of the Trading Misfeasance Claim, Chandler settled all claims against him. Accordingly, the reserved judgment determined the quantum of liability of Chappell and Henningson in relation to the Trading Misfeasance Claim.

The judge again accepted that the starting point for assessing compensation for misfeasance under section 212 of the IA 1986 is the IND. As a second consideration, the judge held it must be proved that the breaches of duty were an effective cause (but not the sole or only effective cause) of the losses which the companies suffered in continuing to trade. It was held that the breaches of duty committed by Chappell and Henningson were the effective cause of the IND, excluding the increase in the pension deficit, between KD3 and the date of the administrations.

Between KD3 and the date of the administrations, the IND was agreed to be £133.5m. Henningson and Chappell were ordered to pay the total sum of £110.23m in equitable compensation to the Joint Liquidators, on a joint and several basis, which excluded the pension deficit and the credit from settlements of co-directors, including Chandler. Whilst liability was apportioned for the Wrongful Trading Claim, the judge declined to exercise discretion to apportion liability in respect of the Trading Misfeasance Claim.

Individual Misfeasance Claims

The Individual Misfeasance Claims consisted of nine separate claims of breach of duty relating to specific assets or funds of the companies. Like the Trading Misfeasance Claim, these were founded on section 212 of the IA 1986 and concerned various breaches of statutory duties under the CA 2006.

As these claims were highly fact-specific, few general lessons can be drawn from them. We therefore simply note for completeness that four of the nine claims were ultimately successful, resulting in Henningson being ordered to pay just under £4m and Chandler being ordered to pay c. £1.67m.

Key takeaways for directors of distressed businesses

Navigating duties during times of financial difficulty has never been more complex or potentially risky

The differences between the more established position in relation to wrongful trading and the position for misfeasant trading, as set out in this judgment, are multifaceted and nuanced. So, whilst the old adage of “every case is different” remains true, taking professional advice remains vital. Moreover, the fact that the quantum of the liability in the misfeasant trading element of the proceedings was so much greater than that for the wrongful trading claim can only serve to increase the risk profile for directors during times of financial difficulty – not only is their potential liability greater, but they may be more likely to be on the receiving end of a claim (as insolvency practitioners (or funders) may be more incentivised to bring such claims in light of the potentially greater recoveries available).

Directors must ensure that they are up to the task

The fate of Chandler provides a clear (albeit extreme) example of the risks assumed by directors who accept roles that they are not qualified to undertake. Chandler came up short when measured against the wrongful trading Notional Director standard and his poor decision-making (caused by inexperience) was a key factor leading the court to conclude that he should not be relieved of liability on the misfeasance claims.

Chandler was also not spared from liability by his honest conduct and good intentions whilst in office, nor by his limited personal means. Indeed, the judge acknowledged that the award of compensation against him would be potentially ruinous but refused to take his ability to pay into account in order to avoid giving a green light to risk-taking directors generally.

Professional advice is a key protection but the court will view it in context

The judgment affirms the general principle that a director who takes and acts upon professional advice will have gone a long way towards evidencing that they have performed their duties with reasonable care. However, the court will consider the context in which the advice was given and have regard to factors such as the scope of the engagement, the instructions which the adviser was given and the knowledge which the adviser had when considering what weight to attach to it.

In this case the respondents' arguments that they placed heavy reliance on the legal advice received were undermined by various factors, including that: (i) the respondents failed to seek advice in advance of certain key decisions and on other occasions failed to table advice for consideration at board level; and (ii) board minutes frequently recorded no genuine discussion between board members about the risk of insolvency or the risks to individual creditors, indicating that the boards were simply going through the motions.

Board minutes in a distressed situation must be a faithful record of proceedings

The judgment contains a nuanced and helpful discussion in relation to when a court will attach evidential weight to board minutes. It confirms that minutes which are clearly intended to be a contemporaneous record will be given more weight than minutes prepared in advance by lawyers to approve a particular transaction (as for example is typical on lending transactions). In a similar manner, less weight was given in this case to wrongful trading language which was originally drafted by the group's lawyers and then simply repeated verbatim in subsequent minutes.

Whilst this is largely common sense, directors of distressed businesses and their professional advisers should take care to ensure that their board minutes avoid these pitfalls so that the ability to place reliance on them in future is not prejudiced.

Directors exercising limited functions may not abdicate decisions for the whole board

The judgment affirms the established law that a board of directors may delegate management functions to each other but warns that a director may be in breach of duty if he leaves to others matters for which the board as a whole must take responsibility. In this case counsel for Henningson submitted that he was distanced from the critical decisions regarding financing as his functions were supposedly limited to introducing financial contacts and dealing with the international business. The judge concluded however that even if Henningson's responsibilities were so limited, it was nevertheless not open to him to leave to his fellow directors those critical decisions which were required to be made by the BHSGL board.

Directors should not assume that they will be shielded by insurance

Mr Justice Leech declined to exercise his discretion to limit the amount for which Chandler and Henningson were liable to the directors' and officers' insurance cover which remained available to them on the basis to do so would be to send the wrong message to risk-taking directors. He also observed that

the amount of cover in place was plainly inadequate to meet the potential claims against the directors given the sums with which they were routinely dealing. Directors may well wish to revisit the adequacy of their own cover in light of these comments.