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(UK) What Is Misfeasance Trading? What Does This Mean for Directors and Their Advisors?

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For those that are that way inclined (which includes us at #SPBRestructuring!), the 500 plus page *Wright v Chappell* judgment which sets out the BHS wrongful trading claim against its former directors makes for an interesting read. It paints a colourful picture of the downfall of the BHS group, from the point that it was sold for £1 to its eventual demise into administration and then liquidation. You can make your own mind up about the characters involved, but the story is a sorry one, with creditors ultimately suffering the most.

The liquidators of the BHS group brought a claim against the former directors for wrongful trading, two of those directors settled the claims against them, and three defended. This recent decision relates to the findings against Henningson and Chandler, with the outcome of the claim against Chappell being dealt with separately.

Ultimately the judge found that both Henningson and Chandler were liable for wrongful trading, but also that they were liable for misfeasance trading in breach of their director duties. But what is “misfeasance trading”? How does this impact director duties? Does this change how practitioners should be advising directors of distressed companies?

Any claim for wrongful trading or misfeasance will turn on its own facts, and we don’t propose to go into the detail of BHS in this blog – read the judgment if you wish to know the ins and outs – but there are, we think, the following key takeaways from this decision.

Wrongful Trading Claims

Although wrongful trading was established in BHS, the bar to establish such a claim remains high.

The liquidators claimed that the directors knew or ought to have known that the company could not avoid going into insolvent liquidation on 6 separate dates – they were only able to establish that the test set out in s214 of the Insolvency Act 1986 was met on the last of these dates.

As noted, the judgment provides a colourful picture of the downfall of the BHS Group. Despite what on the face of it seems to have been culpable or at least extremely questionable behaviour, decision making and failures, the judge was not persuaded that the actions of the directors met the s214 test until late in the day.

Post this decision, it remains the case that succeeding with a claim for wrongful trading under s214 will be difficult. That does not mean however that directors should take that as a green light to continue trading a company in distress without due regard to their director duties: far from it. If anything, the decision brings the need to consider those duties into sharper focus – see further below.

Misfeasance Trading

BHS introduces the concept of misfeasance trading – which in summary, means trading in breach of directors' duties when the company should have gone into administration or insolvent liquidation much earlier if those duties had been complied with.

As noted, there is a high bar to establish a wrongful trading claim which requires an office holder to prove that the directors knew (or should have known) that insolvency was inevitable. However, the risk of misfeasance trading arises much earlier than this – arguably making it much easier to establish.

In BHS the directors were found to have breached a number of duties under the Companies Act 2006 including the:

- duty to act within their powers (s171(b)),
- duty to have regard to the interests of creditors (s172(3)),
- duty to exercise reasonable care, skill and diligence (s174),
- duty to avoid unauthorised conflicts (s175), and
- duty not to accept benefits (s176).

Whether or not a director has breached their duties rests on the action (or inaction) of the particular director which means that these types of decisions are largely confined to their facts. However, there are some takeaways for both advisers and directors of companies – particularly those trading within the "zone of insolvency" – by considering what the directors in BHS did not do and should have done. If they had considered advice they had received and the basis or information on which it was provided, held board meetings and fully documented the reasons for their decisions, this may have resulted in a different outcome for both them and the group itself.

The judge himself indicated that if the board had considered the interests of creditors and decided in good faith that it was in their interests to continue trading, the claims would have been dismissed. The directors were not able to evidence this.

Notably, in BHS the first time the directors were found to have breached their duty to consider the interests of creditors (for the purpose of the misfeasance trading claim) was some 6 months earlier than the date on which the claim for wrongful trading was established.

Professional Advice

The directors of the BHS group took professional advice from respected lawyers and accountancy firms including advice about their directors' duties. Generally speaking, taking (and following) advice when a company is experiencing distress provides a level of protection for directors who might later find themselves on the wrong end of a claim for wrongful trading or misfeasance. There has been some commentary post BHS bringing this into doubt given that the directors did take advice but were still found liable – however that has to be considered in the context of what the directors did and didn't do when taking advice and the parameters of the advice itself.

In BHS although advice was taken it was not always considered by the directors and on occasion it was sought after the event. Although advisers often raised the right questions for the board to consider, these were not then discussed (or, at least the discussions were not documented if they were). In addition, advisers were not always given the complete picture, sometimes the true position was hidden and there were instances where no information was given to the advisers at all.

Further, when it came to key meetings, advisers were not always present or if they were, they were only there for part of the meeting to present on a specific point. Indeed, at some meetings some of the directors were not present either.

In this context, it is understandable why professional advice did not protect the directors as much as they may have wished. There is naturally a limit to the value of advice when information is withheld or is not disclosed, and simply "*going through the motions*" by taking advice but not considering it – as the directors did in BHS –will not cut it. Neither will relying on the view of professional advisers where their view is based on inaccurate information provided by the board. A classic example of the product only being as good as the raw materials used to build it.

Taking proper professional advice, carefully considering and following it, is still (in our view) one of the best ways for boards to enhance their protection if a company is in distress, provided that is, that directors provide their advisers with all material information. As the judge noted in BHS the general position is that a director who takes and acts upon expert advice goes a long way towards performing their duties with reasonable care – as required under s174.

If, however, directors are simply paying lip service to advice, obtaining it to tick a box, are not considering or discussing it, or have not given their advisers the complete picture, then the level of protection that taking advice can provide will be limited – as it was in BHS.

Practitioners will also need to consider the basis upon which they are engaged. The weight to be given to that advice (and therefore the protection it offers) will however depend on the:

- scope of the engagement;
- instructions the adviser was given;
- knowledge which the advisers had or the assumptions which they were asked to make;
- advice which the advisers gave (or did not give); and
- the extent to which the directors relied on that advice (or not).

Calling Meetings and Keeping Records

BHS also illustrates the importance of holding regular board meetings, attending them, recording what was discussed and why a particular decision was made. When the creditor duty is engaged, directors must be able to explain why they did what they did in light of this duty and detailed contemporaneous evidence of that decision making rationale will be key to a defence of their position.

In BHS the directors were found to be in breach of the duty to exercise reasonable care, skill and diligence by failing to call board meetings, attend board meetings, properly minute decisions and their reasons for those decisions, and were also in breach of their duty to consider the interests of creditors – there was no evidence that they had at critical points.

The judge noted that keeping records is an "*important discipline*" but also flagged that standardised minutes that simply say that the directors had considered that they were acting in the best interests of creditors would be given little weight. Clearly minutes should reflect the discussions that have been had and give an explanation and justification to support why the company is continuing to trade or a specific transaction has been entered.

When making decisions, directors should apply "*rational*" thought, provide "*justification*", have an "*honest belief*", apply "*commercial judgment*" and act with "*reasonableness*" and in "*good faith*".

They should not make decisions that are "*irrational*", with "*blind optimism* "or "*wishful thinking"* or ones that are "*fanciful*" or "*overly optimistic*".

Taking expert advice will help inform directors whether their decisions fall into the former or latter category.

Director and Officer (D&O) Insurance

Depending on the terms of the specific policy D&O cover could provide comfort to a director if the policy indemnifies them against claims such as wrongful trading. However, that will not protect a director from personal liability where the policy limit is not sufficient to cover the full claim.

In BHS the judge declined to reduce the amount for which the directors were liable based on the level of cover they had in place and was not prepared to take into account the personal circumstances of one of the directors and their inability to pay. To do so would send the wrong message to risk-taking directors.

As a lesson for the future, check the terms of the policy and the level of cover it provides. A policy may offer comfort when a company is trading through a period of distress, but it may not provide full protection.

Concluding Thoughts

Once insolvency becomes probable (or imminent) a director's duty to promote the success of the company under s172 of the Companies Act 2006 is modified, requiring them to give "adequate consideration" to the interests of creditors. The weight that should be given to those interests differs, depending on where the company sits on the distress curve – the further along it, the more weight that should be given to their interests.

The "zone of insolvency" – as this is often referred to – is a difficult period for any director to navigate. Understanding what it means by considering the interests of creditors, how much weight should be attributed to their interests and whether a decision is the right one in the face of probable insolvency is no easy task.

What BHS does illustrate is that directors cannot escape liability simply because they have instructed professional advisors – paying lip service to the process is not enough. Those advisors need to be properly engaged and be fully informed in order to provide advice, and directors need to heed their advice and document their decisions. Doing that remains one of the best ways that a director can demonstrate that they are discharging their duties and consequently minimise the risk of a subsequent claim against them if the company ultimately enters an insolvency process.

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