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Misfeasance and Insolvent Trading – Risks for BVI Directors

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The recent English High Court decision of ***Wright v Chappell*** related to the collapse of British Home Stores provides a landmark ruling of which directors and corporate service providers of BVI companies need to be aware. A significant award for wrongful trading has been made, along with the first ever finding of misfeasant trading. Directors may be held liable in failing to file for insolvency when it would be in the creditors' interests to do so.

Introduction

- The British Virgin Islands (**BVI**), like England, has a statutory regime relating to insolvent trading and misfeasance that can impose liability on directors for allowing a company to continue to trade when they knew, or ought to have concluded, that it had no realistic prospect of recovery.
- This is an important development of which all BVI professionals, directors and corporate service providers (**CSPs**) should be aware.

Background

This development arises from the English High Court decision of Mr Justice Leech dated 11 June 2024 in litigation related to the collapse of British Homes Stores (*Wright & Ors v Chappell & Ors (Re BHS Group Ltd & Ors (in liquidation) (**Wright v Chappell**)*). For the first time, damages were awarded against directors for 'misfeasant trading'. In addition, a significant damages award was made against the directors for wrongful trading, which is the English equivalent of the insolvent trading regime in the BVI. The decision means that directors may be held liable for failing to file for insolvency when it is in the creditors' interests to do so.

Duty to have regard to the interests of creditors (the 'Creditor Duty')

It is well known that directors generally owe their duties to the company, which is regarded as the body of shareholders as a whole, rather than to individual shareholders.

In 2019 the UK Supreme Court held in *BTI v Sequana* that directors must in certain circumstances also have regard to the interests of creditors. Although the creditor duty in that case arose under section 172(3) of the English Companies Act, the Supreme Court unanimously found that section 172(3) preserved the common law rule recognised in an earlier 1988 English Court of Appeal decision, *West Mercia Safetywear Ltd v Dodds*.

The Supreme Court said that the Creditor Duty is a duty to consider creditors' interests, to give them appropriate weight, and to balance them against shareholders' interests where they may conflict. The duty was variously said to arise where insolvency was imminent, where the company was insolvent or bordering on insolvency or where an insolvent liquidation or administration was probable. It followed that liability could arise where there had been a breach of duty by directors even though insolvent liquidation was not inevitable and where there was no liability for wrongful trading.

Insolvent trading

In order to establish liability for insolvent trading in the BVI, the requirements are similar to the wrongful trading provisions in England. Section 256 of the BVI Insolvency Act (2020 Revision) (the **Act**) is similar in wording to the English Insolvency Act 1986, section 214. The following is required for a finding of insolvent trading:

- the company is in insolvent liquidation;
- at some point before the commencement of the liquidation, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation (the **Knowledge Condition**); and
- the director was director of the company at the time of the Knowledge Condition.

The similarity in wording between the provisions in the BVI Insolvency Act and the English Act suggest that the BVI Courts will likely find the English High Court's decision highly persuasive.

The Knowledge Condition

The Act sets out that facts and conclusions that a director ought to have known or concluded are on the basis:

- of a reasonably diligent person having both the general knowledge, skill and experience to be reasonably expected of a person carrying out the director's functions; <u>and</u>
- of facts that comprise the specific knowledge, skill and experience that the director in question has.

The Knowledge Condition – Key Takeaways

The key takeaways from this decision as regards the Knowledge Condition are set out below.

- Where the director has more knowledge or skill than the objective reasonable director, a higher standard applies. It should be noted that the objective standard is the minimum threshold.
- In ascertaining what a director ought to have known, the Court will look beyond their title and consider their actual function.
- A director is expected to obtain sufficient financial information to monitor the company's solvency.
- In certain circumstances it may be acceptable for a director to permit the company to continue trading even though they know it is insolvent, if to do so is in the best interests of the company and creditors – as long as there is light at the end of the tunnel. If the directors take that route, there must be a rational basis for reaching that conclusion.
- The Court was mindful that putting a company into liquidation should not be unnecessarily encouraged so that directors do it at the first sign of trouble to protect themselves – as such the Court will be conscious of avoiding hindsight when judging a director's decisions.

Misfeasance

The wording of section 254 of the Act is almost identical to the English Insolvency Act equivalent. This is essentially a catch all provision that allows a liquidator to bring a claim where a director, liquidator or anyone involved in the promotion, formation, management, liquidation or dissolution of the company has been guilty of misfeasance or breach of fiduciary or other duty to the company.

The applicable duties include promoting the success of the company, which includes considering the interests of creditors where:

- the company is insolvent or bordering on insolvency;
- insolvent liquidation is probable; or
- a transaction is being entered into which would put the company at risk of either of those two situations.

In *Wright v Chappell*, the directors sought to rely heavily on advice they had sought from legal and accountancy advisers. However, the judge said that the weight to be attached to professional advice would depend on a number of matters, including:

- the scope of the engagement;
- the instructions given to the advisers;

- the knowledge of the advisers and the assumptions that they were asked to make; and
- the advice which they gave and the extent to which the directors relied on the advice given.

Therefore, it is important for directors to ensure that they seek appropriate advice, properly brief their advisers and act on the advice if they wish to rely on that professional advice as a defence to a claim.

Misfeasance – Key Takeaway

The judgment discusses how the directors engaged in 'insolvency deepening' activities in breach of the Creditor Duty. That breach was said to amount to misfeasance. The slightly surprising takeaway is that the 'insolvency deepening' activity was said to have taken place from June 2015, in circumstances where the court also held that wrongful trading did not commence until September 2015. Does this create a wider wrongful trading liability? When in the realms of insolvency, a director is now not only required to consider whether there is a reasonable prospect of avoiding liquidation, but even if there is, they must also take a view on whether the action they are proposing is in the interests of the creditors.

Conclusions

Whilst *Wright v Chappell* was fact specific, the judgment provides key areas where BVI professionals, company directors and CSPs should place their focus in ensuring their duties are discharged. These include ensuring:

- they are fully informed of the company's financial position;
- any plan of action regarding solvency should be justifiable objectively on the misfeasant trading basis;
- directors act with the reasonable care and skill required, which is the minimum threshold;
- precise minutes of meetings are kept to record how professional advice has been considered – to this end *Wright v Chappell* suggests that proper and accurate records of what was discussed are required, rather than formulaic minutes prepared in advance;
- directors obtain proper professional advice and act on that advice, making sure due consideration is given to the interests of creditors, and carefully considering whether the company should be placed into liquidation rather than continuing to trade; and
- not to overly delegate directors' duties.

Directors need to exercise particular care in allowing the company to continue to trade when there is a risk of insolvency and of their activities prejudicing creditors. This is not least because failing to consider matters properly may prevent directors from relying on any indemnities in their favour contained in the company's constitutional documents, and the potential liabilities may considerably exceed the amount of any directors and officers' (D&O) insurance in place.

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