

Client Memorandum

Madoff Directors “Vindicated” by English High Court

This important case confirms that it is not a breach of duty for a director to “defer” to the views of others, nor does a director have to resign merely because he disagrees with a course of action proposed by his board, or shareholders. It also confirms English cases on directors’ duties will continue to be persuasive in the Cayman Islands (despite the recent codification of English law), and serves as a reminder of the difficulties of proving dishonesty in claims against directors.

In a judgment handed down on 18 October 2013, the English High Court has roundly rejected allegations of breach of duty and dishonesty leveled against a number of directors of an English company that was part of the now defunct Madoff Securities Group. This is an important judgment for offshore practitioners because it reinforces and restates established principles, despite the recent codification of the law in England and Wales. It also updates the law on what amounts to a dishonest breach of duty by a director, which was relevant in this case because the claimants needed to overcome time bar issues by alleging dishonesty. This issue is often relevant in claims against directors of offshore companies, whose constitutions may exclude liability for all claims, except those for dishonest breaches of duty.

In this latest chapter in the Madoff saga, the liquidators of an English company within the group alleged that its directors had dishonestly breached their duty to the company by acting on Mr Madoff’s instructions to pay substantial sums for “research” which it was alleged (amongst other things) had been plagiarised and was of no use to the company. The evidence of one of the defendant directors was that he queried the relevance of the research with Mr Madoff and was told, using “*colourful language*”, that, “*You are going to take the research*”. The director deferred to Mr Madoff and, in his defence, argued that it was not a breach of duty to assume that Mr Madoff’s high standing in the financial world equipped him to know what was best for the company.

The Judge noted that the law on directors’ duties had been codified in the English Companies Act 2006. He found that nothing in this case turned upon any distinction, to the extent there was one anyway, between the old common law cases and the more recent statutory codification. The old common law cases are commonly applied in offshore jurisdictions, and, clearly, remain good law there, as well as in England and Wales. The Judge summarised the principles as relevant to this case, taken from the common law cases on the director’s duty to act in good faith in the interests of the company:

- The test is whether the director believed he was acting in the best interests of the company. This is a subjective test.
- It is legitimate and often necessary for there to be division and delegation of responsibility for particular aspects of the management of a company.
- Nevertheless, the director *does* owe a duty to inform themselves of the company’s affairs and join with fellow directors in supervising them.
- It is a breach of duty for a director to become dominated, bamboozled, or manipulated by a fellow director where this amounts to a total abrogation of responsibility.
- It is the duty of each director to form an independent judgment as to whether acceding to a shareholder’s request is in the best interests of the company.
- A director, who has knowledge of his fellow director’s misapplication of company property and stands idly by, taking no steps to prevent it, will be in breach of duty.
- A director is entitled to rely upon the judgment, information, and advice of a fellow director whose integrity skill and competence they have no reason to suspect.
- Corporate management often requires the exercise of judgment, on which opinions may legitimately differ, and requires some give and take. A board of directors may reach a decision as to the commercial wisdom of a particular transaction by a majority. A minority director is not in breach of his duty, or obliged to resign and to refuse to be party to the implementation of the decision by disagreeing. The minority may legitimately defer to the majority views, provided they are advanced in what the minority perceives to be the best interests of the company.
- Where a director fails to address his mind to the question whether a transaction is in the interests of the company, he is not thereby, and without more, liable for the consequences of the transaction. In such circumstances, the Court will ask whether an honest and intelligent man in the position of a director of the company concerned could, in the whole of the existing circumstances, have reasonably believed that the transaction was for the benefit of the company.

Applying these principles to the facts, the Judge found that it would have been unfair and unrealistic to expect the directors to have done anything other than attach great weight to the views of Mr Madoff, in deciding what was in the interests of the

company. Mr Madoff was both a director and shareholder of the company. To take the view that Mr Madoff knew best was not a dereliction of the duty to exercise independent judgment. It was a legitimate recognition that Mr Madoff's high standing in the financial world reflected a level of skill and experience which did indeed equip him to know what was best for the company, and put him in a much better position to make that judgment than the other directors. Accordingly, there was no breach of duty.

As to the allegations of dishonesty, the Judge concluded they were "*unfounded*". The Judge applied the tests, taken from some recent and other older English cases involving trusts, and confirmed the modern approach of the English courts as requiring,

"that in order to prove dishonesty, it is necessary to show that a [director] deliberately committed a breach of [duty] which he did not honestly believe was in the best interests of the [company]."

The requirement to show a deliberate act can be particularly difficult in claims against directors, especially where the allegation involves a failure to act. When looking to bring claims against directors of Cayman Islands companies with well drafted constitutions, it may not be possible to bring a claim at all unless a case of dishonesty can be made out. This is because, unlike in England and Wales, in the Cayman Islands, a company's constitution may contain very widely drawn exclusions of liability for its directors.

This case serves as a timely reminder of the pitfalls of alleging dishonesty, or of assuming that, simply because there has been a significant fraud, that the members of the board must have been implicated in it. The Judge made the following remarks at the conclusion of his judgment:

"I cannot forbear from recording the commendable dignity and restraint which I have observed in each of Mr Raven, Mr Flax, Mr Toop and Mrs Kohn throughout the trial. Bernard Madoff's fraud itself blighted their lives and tainted their good names, simply by association, quite apart from the financial losses suffered by some from investments in the Ponzi scheme. To this was added the burden of this unfounded claim, making serious allegations of dishonesty, which threatened financial ruin and personal humiliation. It was commenced without forewarning – some discovered they were the subject of the claim by reading of it in the newspapers – and have been pursued aggressively and relentlessly over several years. Their honesty and integrity has been vindicated. The resolute and temperate way they have conducted themselves in these proceedings does them great credit."

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A copy of the judgment can be found at:

<http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWHC/Comm/2013/3147.html&query=madoff+and+directors&method=boolean>

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