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UK High Court Clarifies Scope of Directors' Duties

Court holds that directors may legitimately defer to the views of fellow directors if persuaded that the views are in the best interests of the company.

On 18 October, in *Madoff Securities International Limited (In Liquidation) v Raven & others*, the UK High Court held that the directors of Bernard Madoff's London business did not breach their duties of good faith in relation to certain payments made by the company.[1] The court confirmed a number of established principles concerning the scope of a director's duty to act in what he or she believes to be in the best interests of the company. Company directors should be aware that they must exercise independent judgment and remain personally liable for board decisions but that they may, on certain occasions, defer to the views of their fellow directors while still complying with their duty of good faith.

Background

The case concerned a claim brought by the liquidators of Bernard Madoff's London business, Madoff Securities International Limited (MSIL), against its former directors (including Madoff's sons, Andrew and Mark Madoff). Claims were also brought against Sonja Kohn—an Austrian businesswoman who had made introductions leading to large investments in Madoff's U.S. business, Bernard L. Madoff Investment Securities LLC (BLMIS)—and entities with which she was connected. The underlying cause of the case was fraudulent activity conducted by Bernard Madoff through BLMIS. MSIL was not part of the fraud and conducted its own legitimate activities. However, at all material times, Bernard Madoff was MSIL's CEO or chairman and owned virtually all of the voting shares of MSIL.

The liquidators claimed that MSIL's directors breached their duties in permitting the company to make certain payments to entities related to Kohn in return for services, such as written research provided to MSIL. Amongst other allegations, the liquidators claimed that the directors knew Kohn's written research was poor and of no value to the company. Accordingly, in allowing such payments to be made, each of the directors was alleged to have breached duties, including the core duty to act in good faith in the interests of the company. Claims against Kohn were founded upon dishonest assistance, knowing receipt, restitution, and proprietary receipt.

Judgment

In deciding the case, Justice Andrew Popplewell noted that the duty to act in good faith in the interests of the company is a duty to act in what the director believes to be in the company's best interests. The test for whether the duty has been breached is therefore a subjective one and depends on whether the director honestly believed his or her act or omission was in the company's best interests. It does not depend on whether the act or omission was in the best interests of the company or whether the court would have acted in a different way if in the director's place.

Justice Popplewell also confirmed a number of principles regarding the scope of this director's duty. First, he stated that, while it is acceptable for there to be a division and delegation of responsibility for different aspects of a company's management, directors still have inescapable personal responsibilities, including informing themselves of the company's affairs and supervising these with their fellow directors. Therefore, it is a breach of duty for a

1. [2013] EWHC 3147 (Comm), *available at* http://www.bailii.org/ew/cases/EWHC/Comm/2013/3147.html.

director to allow himself or herself to be "dominated, bamboozled or manipulated" by a dominant fellow director where this involves a total abrogation of the director's responsibility.[2] Instead, each director must exercise independent judgment, including whether acceding to a shareholder's request is in the best interests of the company.[3]

Justice Popplewell further confirmed that a director who knows of a fellow director's misapplication of company property, and who does not try to prevent it, will be treated as a party to the breach.[4] Finally, Justice Popplewell affirmed a director is entitled to rely on the judgment, information, and advice of a fellow director if there is no reason to suspect that director's integrity, skill, and competence.[5]

Justice Popplewell also gave novel guidance regarding the scope of a director's duty to act in good faith in the interests of a company. He recognised that corporate management often requires exercising judgment on opinions that may legitimately differ and that management involves "some give and take". Accordingly, a director may defer to the views of his or her fellow directors if he or she is persuaded that the other directors' views are advanced in what they see as the best interest of the company, even if the director is not likewise persuaded.

Moreover, where a board of directors reaches a decision as to the commercial reasonableness of a particular transaction by majority vote, a minority director is not obliged to resign or refuse to be a party to implementing the decision. An individual director does not breach his or her duty as a director merely because he or she would do things differently.

Justice Popplewell ultimately found that none of the directors were in breach of their duties to act in good faith in the interests of the company. He held that the directors honestly believed the payments to Kohn were in the best interests of MSIL. The directors had been told repeatedly by Madoff that the written research from Kohn was valuable to him, and, at the time, the directors had no reason to question Madoff's competence, integrity, or motives. Justice Popplewell made it clear that the directors (and Kohn) had no reason to suspect Madoff's fraud and believed him to be a successful financier of unquestioned probity. While each director had to exercise independent judgment, it was unfair and unrealistic to expect them to not attach great weight to Madoff's views in deciding what was in the best interests of MSIL. It was not, therefore, a dereliction of the duty to exercise independent judgment and not a breach of the duty to act in good faith.

The claims against Kohn also failed, as she was paid reasonable remuneration for legitimately provided services and acted honestly in relation to those services in all material aspects.

Implications

The High Court's decision is useful guidance for directors on how to balance their legal duties as directors against the commercial aspects of their roles, especially in working with other directors. The decision clarifies that directors cannot passively allow others to manage their company while abrogating their personal responsibility and allowing their independent judgment to be compromised. Instead, directors must supervise the actions taken for their companies and form independent opinions as to whether the actions are in the best interests of the company. However, there are occasions when directors may reasonably defer to the views of their fellow directors.

The judgment is also interesting because Justice Popplewell noted that the claim was "unfounded", even though it was pursued relentlessly and aggressively.

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2. *Re Westmid Packing Services Ltd; Secretary of State for Trade & Industry v Griffiths (No 3)*, [1998] BCC.
3. *Lonrho Ltd v Shell Petroleum*, [1980] 1 WLR 627, 634F. This duty is now reflected in section 173 of the Companies Act 2006.
4. *Walker v Stokes*, [2001] QB 902, 921D-E.
5. *Dovey v Corey*, [1901] AC 477 at 486, 492.

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