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Non-Executive Directors: Total Inactivity and Causation of Loss: *Lexi Holdings Plc (in administration) v Luqman* [2008] 2 B.C.L.C. 725

Introduction

The role of non-executive directors has attracted significant media attention in the light of the banking credit crisis. Less well-publicised are the remedies available to the company in the event that a director or directors have perpetrated a fraud on the company and the non-executive directors by their inactivity have failed in their duties to maintain a sufficient knowledge in order to discharge their duties as directors and, in particular, whether the company can establish that the inactivity has caused any loss. Briggs J. in the Chancery Division had to consider this hypothetical question in the context of a shocking scam where all the relevant players had something to hide. His decision raises questions about the suitability of family members as non-executive directors and emphasises the difficulty of establishing liability.

Background

The claimant company, prior to going into administration, provided bridging loan finance to commercial developers to acquire real estate. Its managing director, S, had over a three year period, in what the judge described as a fraud “truly shocking in its scale and audacity”, misappropriated in excess of £53 million and caused further substantial loss by loans to and transactions with parties connected with him, all under the noses of the company’s auditors, solicitors and funding bankers. The defenders M and Z were directors of the company, with Z being the majority shareholder and they were sisters of S. M was the full time head of a local racial equality commission. Their duties, as directed by their fellow directors S and D (a former bank manager) were limited to occasional attendance to sign documents while S and D had the executive responsibility for carrying on the management of the company.

In proceedings brought by the company against S, M and Z (judgment having been obtained against S), the claims made against M and Z were not that they had actively authorised their brother’s fraud but that they had caused the loss by their wholesale neglect in the performance of their directors’ duties, by taking no part in the management or supervision of LH Plc’s business, and by taking no steps to appraise themselves of the manner in which it was being conducted; they should have done this either as members of the close-knit family or in performance of their directorial duties. Summary judgment had been obtained against M and Z on breach of duty since their inactivity was indefensible. The company led evidence at the trial from directors, bankers and auditors to establish that the fraud would have been prevented if M or Z had disclosed to their fellow directors certain crucial matters: S’s previous convictions for dishonesty and loans and transactions with connected companies. The judge approached their evidence with caution because he considered that their evidence of what they would have done had they been given certain information would inevitably be tainted by their desire to cover their own backs against allegations of breach of duty. He cited Colman J. in *North Star Shipping Ltd v Sphere Drake Insurance Plc* [2005] 2 Lloyd’s Rep. 76 at [254]:

“all their evidence is necessarily hypothetical and hypothetical evidence by its very nature lends itself to exaggeration and embellishment in the interests of the party on whose behalf it

is given.”

The law

Whether a director’s breach of duty consisting of total inactivity caused a particular loss to the company raises issues of law, fact and, unusually for company law, hypothesis. The relevant duty is a matter of law and the steps that that duty requires a director to take comes from the factual background including the particular knowledge, experience and skill which he had. The difficulty comes from constructing what Briggs J. referred to at [28] as a “necessarily hypothetical edifice” to ascertain what would probably have happened if the relevant duties had been performed, and therefore whether the losses suffered by a company would probably not have been suffered. While that total failure of duty might establish a director’s unfitness, there is no presumption that a director’s total failure of duty has caused loss. The measure of loss caused by the breach of duty is the difference between a company’s actual financial position and its hypothetical financial position on the assumption that the duties had been performed. The difficulty of proving that the non-executive directors’ omissions, who met only at intervals and who were not directly involved in the wrongdoing, were the cause of a company’s loss comes from the fact that the fraudulent director was usually trusted by all and had deceived even the auditors. In addition, those giving evidence of what they would have done had the directors performed their duties are often implicitly defending their performance of their own obligations in the context of the fraud. The relevant duty derives from a director’s responsibility, shared with the other directors, for the management of the whole of the company’s affairs. In *Re Barings Plc & others (No 5)* [1999] 1 B.C.L.C. 433, Jonathan Parker J. [487] said that directors:

“have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business to enable them properly to discharge their duties as directors ... Whilst directors are entitled (subject to the Articles of Association) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director of a duty to supervise the discharge of the delegated function.”

He added that the “extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director’s role in the management of the company.”

The standard of care (now set out in s.174 of the Companies Act 2006) is the care, skill and diligence exercised by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions of the director in relation to the company and the general knowledge, skill and experience that that director has. This involves an objective and a subjective test: the objective test sets the basic standard so it is no excuse for a director to say he did not have the general knowledge, skill or experience reasonably to be expected of a person carrying out the appointed functions. The subjective test potentially raises the standard by reference to any greater general knowledge, skill or experience which the particular director actually has. Because of the essentially fiduciary nature of the office, a director is expected to apply to the management and custodianship of the company’s property that same degree of care as he might reasonably be expected to apply in the management and custodianship of his own property. The fiduciary nature of the office also affects the question whether, and if so when, resignation may be an appropriate response by a director to circumstances coming to his attention (*Re Galeforce Pleating Co Ltd* [1999] 2 B.C.L.C. 704, at 716). It’s clear from this analysis that context is all-important and that particular care has to be taken that all these factors are separately analysed.

The decision

Briggs J. said at [40] that the first stage in the causation analysis was to ascertain what steps, relevant to the preservation of the company's assets from their brother's fraud, both M and Z would have taken, had they complied with those duties to the requisite standard, rather than adopted an attitude of total inactivity. The judge found that the sisters' role was, in relation to those assets and the prevention of fraud, essentially supervisory and did not call for any general knowledge, skill or experience beyond that required of a person acting as a director of a company. He also found that, in that context, M's experience of managing a racial equality commission did not impose on her duties beyond that of the objectively ascertained minimum, nor were either of them entrusted by the board with any executive function in that regard. This finding seems to give a soft ride to non-executive directors who have accepted a position which in theory represents a safety measure for the company but which in practice is little more than a fig-leaf.

M and Z had argued that since there were directors on the board with greater and more relevant business experience than they had, they were entitled to rely upon them for the necessary supervision of S's work as managing director and that, despite his greater experience, D had not discovered or suspected S's misconduct. They also relied on the fact that the administrators had not caused the company to begin proceedings for alleged breach of duty against him. The judge found that it was their duty to disclose S's previous convictions for dishonesty and loans and transactions with connected companies to their fellow directors but not to the auditors or funding bankers.

Briggs J. then at [87] decided the hypothetical question of what would have happened had M and Z complied with their duties; he found that while the directors would have resigned and the funding bankers would have reduced the funding available to S, he would still have been able to continue his fraud. The large loss suffered by the funding bankers was the result of its lending to the company and its decision to allow S to run the company's affairs unsupervised despite having been told by the former auditors of their suspicions that he was a fraudster in the context of a scheme to obtain VAT input relief fraudulently. Consequently at [151] the judge rejected the company's case that M and Z's undoubted breaches of duty caused the loss primarily occasioned to the company by his fraud. Briggs J. added at [153] that there was always a risk that the complexity of a causation analysis might lead to an inability to see the wood for the trees so that it was necessary to:

“stand back and check whether the outcome of the detailed analysis makes sense against the broader picture ... an allegation reaching [the funding lenders] via [the company]'s former auditors that S had previous convictions would in my judgment probably not have been enough to change the course of history.”

Conclusion

The decision in *Lexi* illustrates the tactical difficulty with bringing proceedings against certain non-executive directors when other non-executives who are equally blameworthy appear to escape the net. The warning in company law textbooks as to the virtual impossibility of proving that non-executive inactivity actually caused the loss suffered as a result of fraud is borne out and suggests that the comfort which their appointment appears to provide can be illusory.