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THE LONDON LITIGATION LETTER

High Court dismisses claims against London directors of Madoff International Securities Ltd.

INTRODUCTION

An English High Court Judge has recently dismissed a £75m claim against, among others, former directors of the Madoff UK entity - Madoff Securities International (MSIL).

At all times, Bernard Madoff was MSIL's CEO or Chairman and owned virtually all of MSIL's voting shares. Whilst he was not a defendant, both of his sons, who were also directors of MSIL, were named as defendants. The claim was brought by the Liquidators of MSIL in the long shadow cast by Bernard Madoff's notorious Ponzi scheme fraud perpetrated through his New York business, Bernard L. Madoff Investment Securities (BLMIS).

There had been no suggestion that the Director Defendants had been aware of the US Ponzi scheme, and yet the Liquidators alleged not only breach of duty, but also knowing dishonesty.

In rejecting the claims, the Judge, Popplewell J, criticised the Liquidators for bringing the proceedings, which had threatened the defendants with financial ruin and personal humiliation, describing the claims as unfounded.

Madoff Securities London Ltd (In Liquidation) v Raven and others

The claims concerned a large number of payments made by MSIL, including some made to entities connected to an Austrian business woman, Mrs Kohn (who was also a defendant in the action). Mrs Kohn was paid by MSIL for providing services to BLMIS namely: advice, research, and the introduction of European institutions and wealthy individuals. Investors introduced to Bernard Madoff by Mrs Kohn had invested billions of dollars in BLMIS. The payments made to Mrs Kohn by MSIL were made pursuant to an agreement between Bernard Madoff and Mrs Kohn that they would be made by MSIL whilst her invoices would be made out to both BLMIS and MSIL.

ALLEGATIONS OF BREACH OF DUTY

MSIL submitted that the Director Defendants had:

1. acted in breach of their fiduciary duties in making or permitting the payments;
2. failed to exercise their powers for the purposes for which those powers were conferred; and
3. failed to exercise reasonable skill, care and diligence.

THE JUDGMENT - DIRECTOR'S DUTIES

The claims were dismissed. Popplewell J held that it was well established that a company director owes a fiduciary duty to the company to act in what he (not the Court) honestly considers to be the best interests of the company. The test was, therefore, a subjective one, namely whether the director honestly believed that his acts or omissions were in the interests of the company.

In the instant case Popplewell J found that it would be unfair and unrealistic to have expected the Director Defendants to question the views of Bernard Madoff in deciding what was in the best interests of the company. None of the Director Defendants or Mrs Kohn suspected the fraud. Indeed it was not suggested that they did, nor that they would have questioned Bernard Madoff, particularly given that he was MSIL's chairman and majority shareholder and had such a high standing in the financial world. Accordingly there had been no breach of duty by the directors.

THE FOUR STAGE TEST FOR THE EXERCISE OF POWER

Popplewell J held that in considering whether there had been a breach of the duty to exercise powers for the purposes for which they were conferred, the Court would apply a four stage test which involves identifying:

1. the power in question;
2. the proper purpose for which such power was conferred;
3. the substantial purpose for which the power was exercised; and
4. whether that purpose was proper.

The Judge held that a director's liability in relation to misapplication of a company's property by exercising a power otherwise than that for which it was conferred, cannot arise unless he knows that it is an improper purpose. Here the purpose for which the power had been conferred was the fulfilment of MSIL's contractual obligations to make payments. Accordingly there had been no exercise of power for a purpose other than that for which it had been conferred.

REASONABLE SKILL AND CARE

On the evidence, Popplewell J found that the directors had acted honestly and reasonably in making the payments as they had honestly considered the payments to be in the interests of MSIL. Therefore, they had not been in breach of fiduciary duties to act in, what they considered to be, good faith and in the interests of MSIL. Consequently the directors had not failed to exercise reasonable skill and care.

The payments had been made pursuant to valid contractual obligations owed to Mrs Kohn's companies under a contract that was valid; that had been fatal to the Liquidators' claims. Further, there had been no breach of fiduciary duty by the Director Defendants in making the payments, nor had any loss been caused to MSIL; that too had been fatal to the claims. The Director Defendants had not sought or obtained any benefit from the payments.

SHAREHOLDER APPROVAL

To cap it all, the Judge found that even if making or permitting the payments constituted a breach by the Defendant Directors of a duty to act in what were perceived to be the interests of the company, or a failure to exercise reasonable skill and diligence, the transactions were ratified by the unanimous approval of the voting shareholders Bernard Madoff, and his brother, Peter. Such shareholder ratification provided the Director Defendants with a complete defence to allegations of breach of duty.

MRS KOHN AS THE BENEFICIARY OF CERTAIN PAYMENTS

Popplewell J held that there was no apparent motive or benefit to Mrs Kohn in the dishonesty which the Liquidators alleged. She had been providing legitimate services for which, through her companies, she was not overcharging according to the market rate, and the payments had been made pursuant to a valid contract. In dismissing the claims against Mrs Kohn, Popplewell J stated that she had been the victim of a "poisonous press release".

In its judgment the Court was not distracted by newspaper reports and stories that surrounded the case. Indeed, the Judge went out of his way to compliment the defendants, by stating: *"I cannot forebear from recording the commendable dignity and restraint which I have observed in each of the defendants"*. He reached his judgment by applying, and reaffirming, well established tests to determine whether the Director Defendants had been in breach of their duties and found on the evidence that they had not.

COMMENT

This case offers a reminder of the difficulties in bringing a claim for breach of duty and dishonesty against a company director. To be successful a claimant has to show that the director has knowingly failed to act in what he or she, and not the Court, considers to be in the best interests of the company. The need to prove this sort of dishonesty on the part of a director, presents a high hurdle for any claimant to overcome.

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