

Recent Cases Involving Directors' Liability

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Introduction

This article reviews recent 2007 case law in England and Wales with regard to attempts by creditors to pursue directors of companies as well as the companies themselves and the reaction of the courts to this continuing trend. In particular this article will examine the following scenarios:

- the fraudulent director;
- the shadow director;
- the inactive director;
- the director liable for signing an agreement when knowing the company was insolvent; and
- the director liable to make a contribution in cases of knowing receipt.

The fraudulent director

The recent case of *Lexi Holdings PLC (In Administration) v Said Luqman and Others*¹ demonstrates the powers that the courts in England and Wales have to use against directors who act in a fraudulently.

Lexi Holdings was a company set up by Mr Luqman whose principal activity was the provision of bridging loan finance for the purpose of real estate acquisition. The Company obtained finance for its activities through a syndicate of banks. By July 2005 the available facility was GBP 120 million and the facility was secured by fixed and floating charges over all of the Company's assets. Under the facility agreement all of the Company's receipts were to be paid into one account to which the lead bank had sole signing rights. However it was alleged that Mr Luqman transferred approximately GBP 53 million belonging to the Company to various bank accounts belonging to himself and his associates.

On 5 October 2006 the Company was put into administration. When the administrators visited the Company's premises they discovered that virtually all the Company's books and papers and almost all of

its computers had been removed. Almost none of the books or computers were ever recovered.

In these circumstances the administrators obtained a worldwide freezing order against Mr Luqman and against various other members of his family and other associates. The order also contained ancillary orders for the disclosure of assets and tracing information, orders for the delivery up of relevant documents, and orders restraining Mr Luqman from leaving the country and requiring the delivery up of his passports.

Mr Luqman failed to comply with various terms of the freezing order which led to an order for his cross examination and following his cross examination an application for his committal for contempt of court. The breaches of the order were as follows:

1. Failure to disclose all his worldwide assets. Mr Luqman produced only a two-page affidavit in purported compliance of his requirement to disclose all his assets. As more information became available to the administrators, Mr Luqman was forced to admit to various bank accounts that he had not previously disclosed; the beneficial ownership of various companies and the ownership of properties in both the United Kingdom and Europe.
2. Mr Luqman was found to have failed to comply with the tracing aspects of the order in that he did not disclose the details behind certain specific payments made by the company which the administrators had been unable to trace independently.
3. Mr Luqman failed to deliver any relevant documents in his possession despite an unless order being made against him that unless he delivered up the documents he would be barred from defending the proceedings. This included failing to produce a single bank statement.

Mr Luqman was therefore found to be in contempt and Mr Justice Henderson gave an initial recommendation that Mr Luqman should be imprisoned for eighteen months (the maximum sentence being two years). However after a further hearing where Mr Luqman

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1 [2007] EWHC 1508 (Ch).

tried to introduce further evidence to show that he was not in contempt with regard to some of the disclosure aspects the sentence was increased to two years as Mr Luqman was found to have deliberately misled the court again.²

In addition due to Mr Luqman's failure to comply with various court orders he was barred from defending the claims subject to a currently outstanding application for relief from sanctions. This will allow the administrators to obtain a default judgment against Mr Luqman which they will then be able to enforce against his various assets.

This case demonstrates the significant powers of the court to deal with directors who fraudulently misappropriate assets belonging to a company from freezing orders to committal orders and in extreme circumstances barring a defendant from defending the proceedings at all. Thus in England and Wales, creditors of a company can find themselves in a strong position to bring pressure on directors against whom they have strong evidence of fraudulent activity to bring about a recovery of monies owed to them.

The shadow director

In the same proceedings the administrators made an application against Mr Luqman's brother, Waheed Luqman, for summary judgment for his alleged role as a shadow director³ in the Company. Waheed Luqman had resigned as a director of the Company on 11 June 2001. However it was the administrators' case that he remained a shadow director of the Company throughout the period of Shaid Luqman's alleged misconduct and therefore owed the same fiduciary duties to the Company as if he had remained a director throughout the relevant period.

Waheed Luqman did not take issue with the fact that he had remained a shadow director throughout the relevant period. The Court however recognised that Waheed Luqman did not authorise every one of Shaid Luqman's alleged misappropriations. However the Court found that Waheed Luqman was sufficiently closely involved in enough examples of Shaid Luqman's alleged misdeeds to make it appropriate, in the absence of any evidence that he did anything to prevent them, to infer that he authorised or permitted the whole of them. The Court found that there was sufficient involvement by, and therefore knowledge on the part of Waheed Luqman, in relation to each of the three types of improper conduct alleged against Shaid Luqman for it to be established that he was aware of a practice of

misconduct by Shaid Luqman in each of these respects. Therefore even though the Court accepted that there was no evidence that Waheed Luqman was aware of all the improper practices of Shaid Luqman the Court found that there was no real prospect that Waheed Luqman would be able to persuade the Court that he was ignorant of any of the three areas of improper practice carried out by his brother. The Court therefore found that Waheed Luqman was liable to the same extent as his brother Shaid Luqman, as having authorised or permitted his brother's misconduct.

This decision should be taken as a warning to individuals who could be found to be acting as a shadow director of a company. It is not necessary for the Claimant to show knowledge by the shadow director of all the misdeeds of a director. It is sufficient to show that the shadow director was sufficiently aware that fraudulent activities were being carried out for the shadow director to be found liable for the full amount of the claim.

The inactive director

In the same application the administrators also sought summary judgment against the sisters of Shaid Luqman, Monuza Akthar Luqman and Zaurian Parveen Luqman. Both sisters were directors of the company at all material times. However the claim against the sisters rested entirely on their inactivity as directors.

The Court recognised that it is now firmly established as a matter of law that no company director may simply leave the management of the company's affairs to his or her colleagues, or to other delegates without committing a breach of duty. This is due to the fact that although the law permits and to an extent encourages delegation by directors of their functions, every delegation by directors of their functions gives rise to an obligation to supervise the delegate.⁴

The sisters sought to justify their complete inactivity upon the basis of not only their trust of their brother but also on the basis that Shaid Luqman was apparently monitored in his activities by three other directors all of whom were experienced professionals. The Court found that although this may reduce the obligations to apprise themselves of the Company's affairs it did not reduce them to nothing. The Court therefore found that the defence of complete inactivity failed the reality test.

However in this case the Court was not prepared to give summary judgment against the sisters. The Court found that for the purposes of summary judgment the administrators were not able to prove the element of causation. The administrators argued that if the

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² [2007] EWHC 2355 (Ch).

³ *Lexi Holdings Plc (In Administration) v Shaid Luqman & Others* [2007] EWHC 652 (Ch).

⁴ *Re Barings plc and Others No 5* [1999] 1 BCLC & *Re Westmid Packing Services Ltd* [1998] 2 BCLC 646.

sisters had taken the trouble to apprise themselves of the nature of the Company's business, or to supervise Shaïd Luqman, they would have discovered that he was involved in unlawful practices. Having then discovered the unlawful practices they would have been in a position to bring them to an end. Although Mr Justice Briggs found that this was a persuasive analysis he was not convinced that it was established to the degree necessary to enable summary judgment to be based on it as he was not persuaded, beyond the possibility of realistic challenge, that a proper discharge of their duties as non-executive directors would have revealed their brother's dishonest practices. Therefore although the Court found that non-activity was no defence it refused to give summary judgment against the sisters.

Even though in this instance summary judgement was not given this decision should still be taken that inactivity as a director is no defence to the fraudulent activity by other directors of a company. This should be taken as a warning to the thousands of directors who play no real part in the affairs of the company in which they are a director.

Signing an agreement which the director is aware the company cannot fulfill

In the recent judgment of *Contex Drouzha Ltd v Wiseman & Another*⁵ the Court of Appeal upheld a Judge's finding that a director who signed a contract which he knew the company could not fulfil, was liable to the counter-party in deceit.

Mr Wiseman was a director of Scott Daniel Limited and signed a framework agreement dated 9 January 1998 containing a promise by the company to pay for goods to be ordered in the future. The Claimant had previous dealings with Scott Daniel Limited and there was a history of late payment for goods ordered by Scott Daniel Limited and at the time the agreement was signed Scott Daniel Limited still owed a substantial amount of money to the Claimant. At the time the framework agreement was signed Scott Daniel Limited was in serious financial difficulty. The framework agreement stated that the Claimant would manufacture 3000 men's garments per month for a period of two years for Scott Daniel Ltd with payment to be made within 30 days of shipment. Following the signing of the agreement Scott Daniel Ltd failed to repay the outstanding debt and failed to make the necessary payments for the delivery of further stock as set out in the framework agreement.

The Judge at first instance found that in signing the agreement Mr Wiseman must have understood that the agreement was meant to formalise relations between the

parties and therefore it was central to the agreement that Scott Daniel Limited would be able to pay for what it had ordered. The Court found therefore that there was deceit in the signing of the framework agreement. The Court stated that that there was no contradiction between a foolish optimism that something will turn up and dishonesty. Specifically, it is perfectly possible for a businessman to practice deceit in order to keep his business alive, in the unreasonable hope that things will come right in the end.

The court distinguished section 6 of the Statute of Frauds Amendment Act 1828 ('Lord Tenterden's Act') which states that an action is not maintainable on representations of conduct unless they are in writing and signed by the party. The court of first instance found in this case that the representation was made in writing and signed by the party to be charged (Mr Wiseman) and therefore that section 6 of Lord Tenterden's Act did not apply.

The Court of Appeal dismissed Mr Wiseman's appeal. The Court of Appeal found that the Judge at first instance had ruled that Mr Wiseman had made an implied representation in signing the agreement and he had not found a representation as to conduct. Therefore Lord Tenterden's Act did not apply. If the judge had found that the representation was a representation as to conduct then Lord Tenterden's Act would have applied. In this particular case the Court of Appeal agreed with the Judge at first instance in that the framework agreement contained a promise of payment on certain terms on which the Claimant would naturally rely before accepting further orders. By promising terms of payment there was therefore a representation that the company had a capacity to meet the payment terms which Mr Wiseman knew to be untrue.

The Court did, however, sound a warning to potential litigants by emphasising that its decision should not be taken as that every contract signed by a director will contain implied representations by that director. Each case will depend on its facts. Nonetheless, litigants and especially creditors of insolvent companies may wish to consider claims in deceit against directors who have signed contracts that the company could not have fulfilled.

Contributions from a third party

In a recent decision of the Court of Appeal⁶ the court found that a Defendant to a claim in knowing receipt of the proceeds of fraud can seek a contribution from third parties in meeting claims if they no longer retained the proceeds of the fraud.

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⁵ [2007] EWCA Civ 1201.

⁶ *City Index Ltd & Others v David Gawler & Others* [2007] EWCA Civ 1382.

In this case the Claimant had been defrauded by one of its employees who had transferred several million pounds to his spread betting account with City Index. City Index made a profit of approximately GBP 3 million. A further GBP 2.5 million had been paid out of the spread betting account. Sporting Index sought a contribution from the directors and auditors who Sporting Index believed had been negligent in allowing the employee to transfer the funds. The claim was summarily dismissed at first instance as the judge found that there was no real prospect of a contribution being ordered as the Defendant as a rule of law or practice should bear 100% of the loss.⁷

The Court of Appeal found that where the Defendant did not retain some or all of the proceeds, it may seek contributions from directors or auditors of the Claimant whose negligence allowed the fraud to take place for those proceeds that the Defendant no longer retains. It will be for the Court to decide whether justice requires apportionment of liability such that the directors or auditors of the Claimant should contribute to any damages payable by the Defendant. In this case the Court of Appeal found that City Index could seek a contribution from the directors and auditors with regard to the GBP 2.5 million that it did not retain.

Directors of companies therefore need to be aware of this greater vulnerability to claims being made against them and the need therefore to ensure that adequate steps are taken to prevent fraud. In addition, this potential liability may leave directors with a conflict when deciding whether the company ought to bring proceedings for knowing receipt which may mean that any vulnerable director should not be involved in deciding whether or not to do so.

Companies should also now be prepared for Defendants to bring strategic claims against directors in knowing receipt proceedings where allegations of negligence which are potentially embarrassing to the company may be made.

Conclusion

As the United Kingdom sits on the brink of another recession it is clear that creditors are looking to maximise the ways to recoup monies owed to them. If 2008 continues in the same mode, the pressure on directors of struggling companies will continue to grow.

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⁷ [2006] EWHC 2508 (Ch).

