MISFEASANCE & MADOFF

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Introduction

1. Section 212 of the Insolvency Act 1986 ("**IA**") is frequently a valuable weapon in the armoury of a liquidator seeking to increase the pool of assets available for distribution to unsecured creditors. This provision, which provides a "summary remedy against delinquent directors", enables the liquidator to pursue claims against a company's former directors on the basis of alleged breaches of the fiduciary and other duties owed to the company.

2. The scope (and limitations) of such claims and the relevant principles applying thereto have recently been considered by Popplewell J in *Madoff Securities International Ltd v Raven* [2013] EWHC 3147 (Comm). This paper will consider the key points which can be derived from that decision and the practical consequences thereof.

Background

3. As might be expected, this case arose out of the collapse in December 2008 of Bernard Madoff's business empire following the revelation that he had operated the largest Ponzi scheme in history, principally through the investment advisory division[1] of his New York company, Bernard L. Madoff Investment Securities LLC ("BLMIS").

4. The case concerned claims issued by the liquidators of Bernard Madoff's London-based company, Madoff Securities International Limited ("MSIL") against its former directors[2] in respect of three sets of payments made by MSIL, namely:

   (a) Payments in the total sum of US$27,059,054 made between 1992 and 2007 to various entities connected with an Austrian businesswoman, Sonja Kohn, which she had agreed with Bernard Madoff would be made by MSIL in return for a range of services provided by her (including introductions to important individuals and institutions; oral advice, information and ideas about global and economic matters; and written research);

   (b) Interest payment in the total sum of approximately US$14m made between 2002 and 2007 arising out of two subordinated loan agreements by which Bernard Madoff lent MSIL a total of US$62.5m; and

   (c) Payments in the total sums of €5,316,629, US$566,535 and £180,009 (including the purchase of a yacht and a car) which were deducted from Bernard Madoff's director's loan account.

5. In respect of each of these sets of payments, the legal bases for the liquidators' claims against each of the former directors were as follows:

   (a) The director acted in breach of the duty to exercise his powers for the purposes for which they were conferred;

   (b) The director acted in breach of the duty to act in the way in which he considered in good faith to be the best interests of the company;

   (c) The director acted in breach of the duty to exercise reasonable care skill and diligence.

1 The company's two other divisions (market making and proprietary trading) carried out legitimate and profitable business activities.
2 In addition, claims were pursued against Mrs Kohn on the basis of dishonest assistance, knowing receipt and restitution. The relevant principles relating to these claims was considered in the talk given by Jeremy Bamford and Simon Passfield at last year's seminar (and the paper in support thereof).

6. In addition, the liquidators claimed that the directors acted in breach of duty in making or permitting the payments made to Mrs Kohn because those payments constituted an unlawful distribution of capital to MSIL's shareholder, Bernard Madoff.

7. In response, each of the directors defended the claim on the following bases:

   (a) He was not in breach of duty in any of the respects alleged;

   (b) The *Duomatic* principle applied because the payments were approved by the voting shareholders[3];

   (c) Any breach of duty was not causative of any loss: Bernard Madoff would have procured the payments to be made had the director not been in breach of duty as alleged;

   (d) MSIL suffered no loss in respect of the payments because they were funded by BLMIS and so were cash neutral for MSIL;

   (e) The claim failed under the *ex turpi causa* doctrine, because it was MSIL's case that the payments were funded from the fraudulent Ponzi scheme, and were part of it in the sense that the entities connected with Mrs Kohn were being paid for introductions to the scheme.

   (f) Claims in respect of payments made more than six years prior to the issue of the Claim were time-barred;

   (g) The directors should be afforded relief from sanction under section 1157 of the Companies Act 2006 and its statutory predecessors, on the grounds that they acted honestly and reasonably and ought fairly to be excused from liability.

8. In determining whether any of the liquidators' claims were made out and, if so, whether any of the directors was entitled to avail himself of any defence, Popplewell J conducted an exhaustive review of the relevant legal principles, which we will consider below.

Directors' Duties

9. It is trite law that the directors of a company owe a number of fiduciary and other duties to the company. These duties have now been codified in ss 171-177 of the Companies Act 2006 ("**CA**").

10. Where the company is clearly solvent, those duties are owed to the members as a whole. However, where the company is insolvent, of "doubtful solvency" or "on the verge of insolvency", the directors must also have regard to the interests of the company's creditors as a whole (cf Secretary of State for Business, Innovation and Skills v Doffman (No 2) [2010] EWHC 3175 (Ch); [2011] 2 BCLC 541 and GHLM Trading Limited v Maroo [2012] EWHC 61 (Ch); [2012] 2 BCLC 369).

The Duty to Act in Good Faith

11. By s 172(1) CA[4], a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (described by Popplewell J as "the core duty of a director").

12. The test is a subjective one. The duty is to act in what the *director* believes, not what the court believes, to be the interests of the company (*Re Smith & Fawcett Ltd* [1942] Ch 304). However, the director may have difficulty in persuading the court that he honestly believed that an act or

[3] Bernard Madoff held all bar one of the voting shares in MSIL, which was held by his brother Peter Madoff.
[4] At common law, this was expressed as a duty to act in what the director "honestly" considered to be the interests of the company.

omission which resulted in substantial detriment to the company was in the company's interest (cf *Regentcrest Plc v Cohen* [2001] BCC 494).

13. By s 173(1) CA, a director must exercise independent judgment.

14. In consequence, a director owes a duty to inform himself of the company's affairs and join with his fellow directors in supervising them. Accordingly, whilst it is permissible for the directors to divide and delegate responsibility for particular aspects of the management of a company, it is a breach of duty for a director to allow himself to be dominated, bamboozled or manipulated by a dominant fellow director where such involves a total abrogation of this responsibility (cf *Re Westmid Packing Services Ltd; Secretary of State for Trade & Industry v Griffiths (No 3)* [1998] BCC 836 at 842B-843D; *Re Barings Plc (No 5)* [1999] 1 BCLC 433 at 486h-489c; *Lexi Holdings Plc v Luqman* [2009] BCC 716) or to accede to a shareholder's request without considering whether is in the best interests of the company (*Lonrho Ltd v Shell Petroleum* [1980] 1 WLR 627).

15. Further, 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 himself be treated as party to the breach of fiduciary duty by his fellow director in respect of that misapplication by having authorised or permitted it (*Walker v Stones* [2001] QB 902 , 921D-E; *Gidman v Barron and Moore* [2003] EWHC 153 (Ch) at [131]; *Neville v Krikorian* [2006] EWCA Civ 943 , [49]-[51] and *Lexi Holdings v Luqman (No. 1) [2007] EWHC 2652* (Ch) at [201]-[205]).

16. A director is entitled to rely upon the judgment, information and advice of a fellow director whose integrity skill and competence he has no reason to suspect (*Dovey v Cory* [1901] AC 477 at 486).

17. Moreover, where a decision as to the commercial wisdom of a particular transaction is reached by a majority of the board of directors any minority director is not thereby in breach of his duty, or obliged to resign and to refuse to be party to the implementation of the decision; a director may legitimately defer to the views of his fellow directors where he is persuaded that they are advanced in what they perceive to be the best interests of the company, even if he is not himself persuaded.

18. If a director fails to address his mind to the question whether a transaction is in the interests of the company, 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. If so, the director will be treated as if that was his state of mind (*Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62 at 74E-F).

The Duty to Exercise Powers for the Purposes for which they are Conferred

19. By s 171 CA a director of a company must act in accordance with the company's constitution, and only exercise powers for the purposes for which they are conferred.

20. This duty is distinct from the duty to act in good faith; a power may be exercised for an improper purpose notwithstanding that the directors bona fide believe it is being exercised in the company's best interests (*Hogg v Cramphorn Ltd* [1967] 1 Ch 254, 266G-269A).

21. The court will apply a four stage test which involves identifying:

    (1) the power whose exercise is in question;

    (2) the proper purpose for which such power was conferred;

    (3) the substantial purpose for which the power was exercised in the instant case; and

(4) whether that purpose was proper.

22. It is unclear whether liability for breach of this duty is strict or depends upon knowledge or fault on the part of the directors (compare *Progress Property Co Ltd v Moore* [2011] 1 WLR 1 with *Revenue and Customs Commissioners v Holland, In Re Paycheck Services 3 Ltd* [2010] 1 WLR). Popplewell expressed the view that such liability was fault based. However, his comments in this respect were strictly *obiter*.

The Duty to Exercise Reasonable Care Skill and Diligence

23. By s 174(1) CA a director of a company must exercise "reasonable care, skill and diligence", meaning the care, skill and diligence that would be exercised by a reasonably diligent person with: (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and (b) the general knowledge, skill and experience that the director has.

24. Accordingly, the standard of care required of a director is to be determined not only subjectively by reference to his particular knowledge, skill and experience but on general, objective criteria: (*D'Jan of London Ltd, Copp v D'Jan* [1993] BCC 646, 648D-E).

25. A director employed under a contract of employment is bound by an implied term thereof to exercise reasonable skill and care.

26. Directors' and employees' duties to exercise reasonable care, skill and diligence are not fiduciary in character.

The Court's Findings on Breach

27. In relation to the payments made to Mrs Kohn, the court concluded that:

    (a) Applying the four stage test, there was no exercise by any director of a power for a purpose other than that for which it was conferred;

    (b) Two of the directors (Mr Flax and Mr Raven) honestly considered the payments to be in the interests of MSIL. Accordingly, there was no breach of the duty to act in good faith and no failure to exercise reasonable care and skill;

    (c) The remaining three directors (Mr Toop, Andrew Madoff and Mark Madoff) reasonably assumed that there was nothing wrong with MSIL making the payments, but did not address their mind to the specific question whether or how they conferred any benefit on MSIL. However, an honest and intelligent man in their position could reasonably have believed that the payments were in the interests of the company. Accordingly, there was no breach of the duty to act in good faith but there was a breach of the duty to exercise reasonable care and skill.

28. The court rejected all claims of breach of fiduciary duty in relation to the other two sets of payments.

THE DEFENCES

In dealing with the defences, the court focused firstly on the payments made by MSIL to Mrs Kohn (the "MSIL Kohn payments") and then subsequently the interest payments and lifestyle payments. These notes track the court's consideration of these matters.

THE MSIL KOHN PAYMENTS

No breach

Acting in good faith in the best interests of MSIL

29. The traders in London treated the research received from Kohn as of no practical value in their day to day activity. However, it was apparent that Bernard Madoff (a director and major shareholder of MSIL) valued the advice and research of Kohn and he confirmed that he passed on advice from Kohn to traders in London during telephone conversations.

30. A number of factors informed the enquiry as to whether the directors were acting in what they considered to be the best interests of MSIL:

    a. The court held that the *"propriety of making the payments could not be divorced from the context of their funding"*. The directors honestly and reasonably believed that the MSIL Kohn payments were being fully funded by BLMIS and were cash neutral for MSIL. The payments cost MSIL nothing in commercial terms and involved no significant foreseeably risk. That in itself is not sufficient to make the payments in MSIL's interests: some perceived benefit must also have been identified, not merely an absence of detriment. However, the perceived value to MSIL need only have been relatively slight for the directors to hold the honest perception that the payments were in MSIL's interests.

    b. Provided that MSIL was solvent and not doing anything unlawful or contrary to the Companies Acts, as was the apparent position at the time, a director who honestly believed that a payment was in accordance with the wishes of Bernard Madoff could treat that alone as a reason for believing the payment was in the interests of MSIL.

    c. To take the view that Bernard Madoff "knew best" was not a dereliction of duty to exercise independent judgment but a legitimate recognition that Bernard Madoff's high standing in the financial world reflected a level of skill and experience which did equip him to know what was best for the company.

    d. The payments were not secret; they were openly recorded in the company's books and reported to KPMG and the accounting treatment of them was sanctioned by the audit team there.

    e. The services provided by Mrs Kohn could honestly and reasonably be perceived as of benefit to MSIL in a number of ways:

        i. Kohn was introducing Bernard Madoff to influential figures in the European financial services industry.

        ii. Bernard Madoff wanted to grow the London business and therefore profile raising in the media and introductions leading to potential new clients would be of value.

        iii. The written research was of some limited value to MSIL in day to day trading activity and management decision making.

        iv. The New York and London business were intertwined. A benefit received in New York could honestly and reasonably be perceived as being of indirect benefit to MSIL in London.

31. As Flax commented during the trial: *"If the chairman and major shareholder of MSIL tells me he's getting a benefit from it, I have very great difficulty arguing with that".*

32. Mr Raven commented: *"When the research started coming in … I had absolutely no idea what is was, whether it was good, bad or indifferent. Mr Madoff wanted it, Mr Madoff made it quite clear he was going to continue to pay for it and receive it, and so that's fine, for me. My chairman and the shareholders said "you are going to take research", I am not going to argue against that … because I had huge respect for Mr Madoff and his successes and his position in the industry, in New York and with us in London".*

Exercising powers for the purposes for which they are conferred

33. This was dealt with very succinctly by the court. The power exercised was application of the company's property to meet its contractual obligations. The power was conferred in order for the company to meet its contractual obligations and that is the purpose for which it was exercised.

34. The relevant *conduct* was the causing or permitting of the payments, not the entering into the contract with the Kohn entities, which none of the defendant directors did.

Unlawful distribution of capital

35. Again, this was dealt with in relatively short order. The distributions out were funded by BLMIS (on a non-repayment basis) and therefore the funds flow was circular, even if the payments to Kohn could be treated as an unlawful distribution of capital.

36. Popplewell J used the following analogy; *"If Company A wishes to pay for services it is to receive from a third party by donating capital to its wholly owned subsidiary, Company B, to pay the third party for the services, can it really be said that the substance of the transaction when Company B pays the third party for the services is that Company B is distributing capital to its shareholder, Company A?"*

37. There was some debate around whether the payments to Kohn were funded in advance or by reimbursement. However, by the time payments started to be made without *prior* funding, there was an established track record of BLMIS funding the payments, which it always did. It was unthinkable that Bernard Madoff would leave MSIL out of pocket for such large payments and risk the solvency and reputation of a company bearing his name.

Failure to exercise reasonable skill and care

38. Here the court held that Raven and Flax honestly and reasonably believed that the payments were in the interests of MSIL.

39. As noted above, in the case of Toop and Andrew and Mark Madoff, the court held that they had failed to address their minds to the question of whether the payments were in the interests of MSIL and had therefore breached their duty to exercise reasonable skill and care.

Duomatic

40. *Re Duomatic [1969] 2 Ch 365, [1969] 1 All ER 161, [1969] 1WLR 114* – Buckley J said: *"where it can be shown that all shareholders who have a right to attend and vote at a general meeting of the company assent to some matter which a general meeting of the company could carry into effect, that assent is as binding as a resolution in general meeting would be."*

41. Neuberger J summarised the principle in *EIC Services Ltd v Phipps [2003] EWHC 1507(Ch), [2003] 3 All ER 804, [2003] 1 WLR 2360*: *"The essence of the Duomatic principle, as I see it, is that, where the articles of a company require a course to be approved by a group of shareholders at a general meeting, that requirement can be avoided if all members of the group, being aware of the relevant facts, either give their approval to that course, or so conduct themselves as to make it inequitable for them to deny that they have given their approval. Whether the approval is given in advance or after the event, whether it is characterised as agreement, ratification, waiver, or estoppel, and whether members of the group give their consent in different ways at different times, does not matter."*

42. Bernard Madoff held all bar one of the voting shares in MSIL; the remaining share was held by his brother, Peter Madoff.

43. MSIL contended:

    a. That Peter Madoff was unaware of the Kohn payments and therefore there cannot have been unanimous informed approval of the voting shareholders;
    b. That MSIL was at the time of the relevant payments insolvent or was at least in a precarious financial state; and

    c. The transactions were not honest or bona fide from the point of view of the directors or the relevant shareholder, Bernard Madoff.

44. *Duomatic* does not permit shareholders to do informally what could not have been done formally by way of resolution at a meeting. It also cannot apply:

    a. to relieve the directors of liability in respect of transactions that are *ultra vires*;

    b. to breaches which amounted to unlawful payment of dividends; or

    c. to the exercise of powers for an improper purpose.

45. Therefore, in this case, it could only apply to breaches by the directors of their duty to act in what they considered to be the interests of the company or their duty to exercise reasonable care skill and diligence.

46. The court found that Peter Madoff was aware of the Kohn payments and approved them.

47. The court looked at the solvency of MSIL. It considered that the solvency (or otherwise) must be objectively considered. As a matter of fact, the court held that the directors did at all material times reasonably believe that MSIL was solvent.

48. The allegation of insolvency was founded on the fact that payments from BLMIS to MSIL were derived from money stolen by Bernard Madoff from customers as part of his Ponzi scheme. For that reason, those monies were said to be immediately repayable by MSIL to BLMIS.

49. The court agreed that the burden of proving solvency generally lies on the party invoking the *Duomatic* principle. However, here the court was satisfied that it was for the claimant to establish insolvency. This was primarily because, according to accounts and records, MSIL was solvent. It was only insolvent if it owed the debts to BLMIS. Since the claimant asserted the existence of such debts, it was for the claimant to prove that which he asserted.

50. After some detailed analysis and expert evidence, the court concluded that at least US$71 million and possibly considerably more of the payments which went from BLMIS to MSIL could not be traced back, even indirectly, to customer deposits in the BLMIS investment advisory business and therefore treated as stolen monies. That sum being greater than the greatest net asset shortfall identified for MSIL at any stage, at no stage did MSIL appear to be insolvent.

51. In any event, the court also held that the restitutionary obligation to return stolen monies would falter because of MSIL's 'change of position' defence – it had used the funds for MSIL's business. This was unaffected by any knowledge of Bernard Madoff that the funds were stolen; the persons whose state of mind was relevant were those responsible for changing MSIL's position, i.e. the innocent directors in London causing MSIL to make the payments.

52. The allegations around the *bona fides* of Bernard Madoff approving the payments as shareholder centred on the submission that he was using MSIL as a vehicle for money laundering the proceeds of his fraudulent Ponzi scheme. That required the claimant establishing that the funding for the MSIL Kohn payments was traceable to the investment advisory business customer deposits and that both Peter and Bernard Madoff knew that to be the case. This was not made out.

53. The court therefore held that *Duomatic* did apply, in particular to relieve Troop and the Madoff brothers for breaches in failing to address their minds to whether the Kohn payments were in the interests of MSIL.

No causation

54. If there was a breach of duty then it did not cause any loss. The defendants said that Bernard Madoff would have procured the payments to be made by replacing non-compliant directors with compliant ones.

55. Having found no actionable breach of duty, the court held that the issues of causation and remedy did not arise.

56. However, the court did confirm that the remedy for a misapplication of company property in breach of fiduciary duty was restitutionary – there was generally no room for an enquiry as to whether the payments would have been made but for the breach or what would have happened had the payments not been made.

57. The court had found that Toop and the Madoff brothers were in breach of their duty to exercise reasonable skill and care by failing to address their minds to the question whether the payments were in the interests of MSIL. The court concluded that, had they done so, they would have concluded that the payments were in the interests of MSIL and therefore the breach was not, in any event, causative of any loss.

MSIL suffered no loss

58. The payments were funded by BLMIS and so were cash neutral for MSIL.

59. There were two aspects to the claimant's case here:

    a. The issue of loss was *legally* irrelevant. Amongst other cases, *Bairstow v Queens Moat Houses plc [2001]EWCA Civ712, [2001] 2 BCLC 531, [2002] BCC 91* was relied upon to demonstrate that the remedy for breach of fiduciary duty resulting in misapplication of the company's property is one of *restoration*.

    b. The funding by BLMIS was *factually* irrelevant as collateral or subsequent to the breach.

60. Neither argument was accepted by the court.

61. The arguments around restoration and there being no room for enquiry as to whether a distribution (the cases relied upon related to unlawful dividends) would have been made but for the breach or what would have happened had the distribution not been made *do not* compel the court to ignore the *effect* on the company of the transaction comprising the distribution itself.
62. The liability to restore is to put the company in the same position as if there had been no breach. By way of analogy, to require restoration of the full price of an investment, without crediting its value, would not be restoration but augmentation of the company's position.

63. The court held that the payments and the funding from BLMIS were part of a single transaction: *"the payment would not have been made but for the funding, and the funding would not have been provided had the payment not been going to be made. Funding and payment were clearly two aspects of a single transaction."*

64. In distinguishing *VTB Capital plc v Nutritek International [2012] CLC 431*, the court held that VTB's funding had been by way of a loan, whereas BLMIS provided funding by way of donation. The transactions/ payments were therefore asset neutral for MLIS where they had not been for VTB.

65. Accordingly, the court concluded that the 'no loss' defence succeeded in defeating the claim.

Ex turpi causa

66. *Holman v Johnson (1775) 1 Cowp 341, 343, 98 ER 1120 [1175-1802] All ER Rep 98*: *"No court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act."*

67. The defendants argued that in making the MSIL Kohn payments, MSIL was being used by Bernard Madoff as a vehicle to perpetrate and conceal the fraud perpetrated by the Ponzi scheme and to launder the proceeds of such fraud.

68. Firstly, this required a sufficient *connection* between the illegality and the claimant's claim. Following a review of the authorities, the court followed the recent decision of *Jetivia SA and Urs Brunscweiler v Bilta (UK) Limited (in liquidation) [2013] EWCA Civ 968, [2013] SWTI 2677* in which Patten LJ endorsed *Stone & Rolls Ltd v Moore Stephens [2009] 1 AC 1391* re-affirming "reliance" as the correct test, i.e. whether the claimant had to plead or rely upon his own illegality.

69. The court found that MSIL's claim was not founded on any illegality. The claim against the directors did not require MSIL to plead or prove any wrongdoing on the part of Bernard Madoff. The Ponzi scheme merely constituted the "occasion" for the claim, not the *"basis for nor an ingredient of it".*

70. The second limb of *ex turpi causa* is attribution. The principle was set out in *In re Hampshire Land Co [1896] 2 Ch 743, 65 LJ Ch 860, 3 Mans 269*: in a claim brought by a company for losses caused by a director's fraud or other unlawful conduct, the law will not attribute to the company the fraud or other unlawful conduct.

71. *Stone & Rolls (above)* is authority that there is an exception in the case of a one man company and there is no separate constituency of innocent directors or shareholders.

72. MSIL was not a one man company and therefore the *Hampshire Land* principle could apply. The directors therefore argued that MSIL was not a victim of the fraud but merely the vehicle through which it was perpetrated or concealed.

73. *Jetivia v Bilta (above)* confirmed that being a "*secondary victim*" is still sufficient to trigger the *Hampshire Land* principle. However, the reason that was sufficient in *Jetivia v Bilta* was because the defendants were seeking to attribute to the company the very wrong in which they were complicit, so as to avoid liability.

74. The defendants sought to attribute Bernard Madoff's knowledge of fraud to MSIL for the purposes of a claim which was made by MSIL, not against him but against the other directors, who were innocent. The *ex turpi causa* defence failed solely on the first ground of *reliance*. Had that test been met then the defence would have succeeded on the grounds of attribution.

Limitation

75. Section 21 Limitation Act 1980 provides: *"no period of limitation prescribed by this Act shall apply to an action by a beneficiary under a trust, being an action (a) in respect of any fraud or fraudulent breach of trust to which the trustee was a party or privy"*.

76. *Paragon Finance plc v DB Thakerar & Co [1999] 1 All ER 400, 1 ITELR 735, 406c-f*: Fraudulent breach of fiduciary duty is a distinct cause of action from simple breach of fiduciary duty and it requires dishonesty.

77. In *Fattal v Walbrook Trustees (Jersey) Ltd [2010] EWHC 2767 (Ch), [2012] Bus LR D7*, Lewison J said: *"that in order to establish dishonesty it is necessary to show that a trustee deliberately*

committed a breach of trust which he did not honestly believe was in the interests of the beneficiaries."

78. The court found that Raven and Flax were not dishonest in making the payments and that Toop and the Madoff brothers did not act with reckless indifference or deliberately act in breach of trust.

79. Section 32 Limitation Act 1980 provides: *"where in the case of any action for which a period of limitation is prescribed by this Act, either… any fact relevant to the Plaintiff's right of action has been deliberately concealed from him by the Defendant … the period of limitation shall not begin to run until the Plaintiff has discovered the fraud, concealment or mistake (as the case may be) or could with reasonably diligence have discovered it."*

80. The court found that there was no concealment – the payments and their funding were patent from MSIL's books and records and were known to the auditors.

81. Accordingly, the claims in respect of MSIL Kohn payments made before 8 December 2004 were statute barred having occurred more than six years prior to the issue of the claim form.

Acted honestly and reasonably

82. The directors should be afforded relief under section 1157 Companies Act 2006 on the grounds that they acted honestly and reasonably and ought fairly to be excused.

83. The court held that Raven and Flax had acted honestly and reasonably in making the payments and that Toop and the Madoff brothers, although in breach of duty for failing to apply their minds to whether the payments were in the interests of the company, nevertheless acted reasonably.

84. Popplewell J went on to say: *"Had I found that any of the director Defendants was liable or potentially liable in respect of any of the MSIL Kohn Payments, I would have held that he ought fairly to be excused from any liability in the circumstances, in particular where:*

    a. *He acted reasonably and honestly throughout;*

    b. *The payments caused MSIL no loss;*

    c. *The directors did not seek or obtain any benefit from the payments;*

    d. *The payments were approved with full knowledge by all the voting shareholders of the company;*

    e. *The degree of fault, if any, was venial; and*

    f. *The consequences of imposing any personal liability would be unduly harsh, and disproportionate to any degree of fault."*

INTEREST PAYMENTS

85. The claims and defences mirror those in respect of the MSIL Kohn payments.

86. MSIL alleges breach of duty by:

    a. Causing MSIL to enter into the loan agreements (save for Toop);

    b. Causing or permitting the interest payments to be made.

No breach

87. The court found that the directors reasonably and honestly believed that the loans were in the interests of MSIL because:

    a. The loans were on commercial terms, approved by the FSA and recorded openly in the company's books and accounts;

    b. The loans were in accordance with the wishes of Bernard Madoff, the chairman and almost sole voting shareholder;

    c. Bernard Madoff's plans for expanded trading in London were not rigidly formulated – there was no reason at the relevant time to think that the capital would not be required; and

    d. There was no reason to think that the combination of investment income and trading profit generated would be insufficient to meet interest payments and, in any event, any shortfall would be made good by the subventions by BLMIS, i.e. there was no reason to think that MSIL would suffer any loss.

Exercise of powers for improper purpose

88. The power to borrow money was exercised for that purpose and the meeting of interest payments was the fulfilment of the contractual obligations of the company. Both powers were exercised for the purposes for which they were granted.

Duomatic

89. The court found that Peter Madoff was aware of the loan agreements and therefore that the *Duomatic* principle applied, for the reasons explained above.

Causation

90. The same principles outlined above were considered.

No loss

91. Although no final decision was reached on whether the interest payments exceeded the return on the use of the loan capital, the court did comment that any loss would have been met by the subventions from BLMIS.

92. Although less directly linked, again the court reached the conclusion that the funding of the interest payments was not "collateral". The purpose of the funding was to reimburse MSIL and to render the payments, at worst, cash neutral for MSIL. It would be wrong to look at one aspect of this transaction and not others.

Ex turpi causa

93. This defence again failed because of the "reliance" test outlined above.

Limitation

94. There was no fraudulent breach of deliberate concealment and so the limitation period applicable was 6 years. Accordingly, any claim relating to the loan agreements themselves or interest payments prior to 8 December 2004 were statute barred.

95. Accordingly, any claim relating to the loan agreements themselves or interest payments prior to 8 December 2004 were statute barred.

Relief

96. Again, Popplewell J commented that, had he found that any director Defendant was liable or potentially liable in respect of the interest payments, he would have held that he ought fairly to be "*excused from any liability in the circumstances, in particular where:*

a. *He acted reasonably and honestly throughout;*

b. *The payments caused MSIL no loss;*

c. *The directors did not seek or obtain any benefit from the payments;*

d. *The payments were approved with full knowledge by all the voting shareholders of the company;*

e. *The degree of fault, if any, was venial;*

f. *The consequences of imposing any personal liability would be unduly harsh, and disproportionate to any degree of fault."*

THE LIFESTYLE PAYMENTS

97. The payments made reduced Bernard Madoff's directors loan account (which was always in credit) by an equivalent amount.

98. There was nothing secret about the payments or their deduction from the loan account; they were recorded openly in the company's books and records and disclosed to the auditors.

99. There would have been no impropriety in the money being repaid to Bernard Madoff, rather than at his request to the provider of the goods and services. It was not suggested that the company was insolvent or of doubtful solvency or that the payments unfairly prejudiced creditors or that the directors believed or had reason to suspect that the payments involved any illegality or money laundering. The court described the allegation of breach of duty as "hopeless".

CONCLUSION

All claims against each Defendant were dismissed.

Popplewell J described the *"burden of this unfounded claim, making serious allegations of dishonesty, which threatened financial ruin and personal humiliation"* and commended the Defendants on their dignity and restraint throughout the proceedings.

Simon Passfield, Guildhall Chambers
Philip Winterbourne, Temple Bright LLP
May 2014