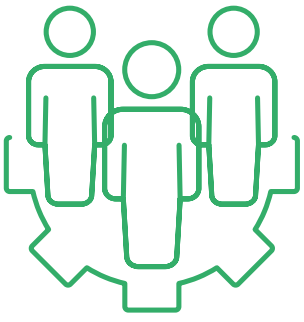
WHEN DOING NOTHING IS NOT ENOUGH

THE LIABILITY OF DIRECTORS FOR INACTION

Authored by: Daniel Lewis (Barrister) – Wilberforce Chambers

"The only thing necessary for the triumph of evil is for good people to do nothing" (JFK, 1961, misattributed to Edmund Burke).

This popular adage is not true. The inaction of "good" people is not the only thing necessary for the triumph of evil; what is necessary is for "bad" people to act to advance their cause. In company law terms, when will the "good" director be in breach of duty for doing nothing to stop a "bad" director? When is it open to the "good" director to say that the loss would have happened anyway regardless of what he or she might have done to stop the "bad" director?



Collective responsibility

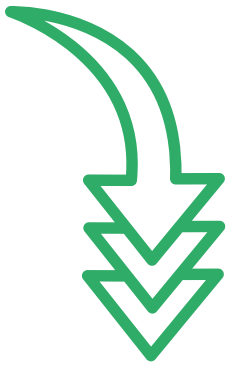
It is often said that directors have "collective responsibility" for the decisions they take. That might suggest that – just as a government minister is (or perhaps, was) expected to publicly support the collective decisions of the cabinet – a director is answerable for the board's collective bad decisions. The principle of collective responsibility is however based upon individual responsibility. Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. In doing so, a proper degree of delegation and division of responsibility is permissible.

The liability of a director for the decisions and actions of others can arise in two situations: (i) the "complete abrogation" cases; and (ii) the "delegation" cases.

Complete abrogation

These are the cases where the defendant director has done absolutely nothing – they neither made the decisions which caused the company loss, but nor did they do anything to inform themselves of the decisions being taken or to consider whether they were in the company's best interests. This most commonly arises in the context of "family" companies where the running of the business is left to certain family members.

The classic example of this was Re Park House Properties Ltd [1998] B.C.C. 847. Memorably, when asked what his reaction would have been had his wife and co-director raised some question over breakfast about the preparation or filing of annual accounts or the payment of VAT, the director said he would have choked on his cornflakes. In these types of case, the inactive director may be found liable since "if he does nothing, he is likely to be in breach of his duties, and if the company is involved in inappropriate activity, he risks associating himself with, and taking some responsibility for, that inappropriate activity".



Delegation "down"

In contrast to the complete abrogation cases, there are those cases where the director has delegated certain responsibilities to others. They can be thought of as involving either delegation "down" or delegation "up".

Delegation "down" is where the director

delegates a specific function to someone below them in the management structure. There are a number of potential stages to the question of liability for "delegation down":

- **Was the function one which it was reasonable to delegate in the first place?** There are some functions that can be described as non-delegable, for example the duty of a financial director to review the company's financial statements and satisfy themselves of their accuracy.
- **Was the delegate a reasonable person to whom to have delegated the function?** In particular, were they reasonably believed to be competent and honest? Were they known to be amenable to proper supervision and control?
- **Having delegated the particular function, did the director exercise proper supervision of the discharge of the delegated functions?** To what extent did the director monitor the performance of the delegated functions, to satisfy themselves both that the instructions given were being followed and that they were being performed competently.

Unlike the complete abrogation cases, the delegation "down" cases depend upon the reasonableness of the decisions taken, unless the delegated function was by its nature non-delegable or the director failed in the irreducible obligation of supervision.

Delegation "up"

Delegation "up" can encompass a range of behaviour. The most common is where the director relies upon the competence of an executive director in their area of responsibility. As with delegation "down" the question will be whether the reliance placed upon that co-director was reasonable, taking into account the fact that, for a company to function, a director is not required to treat every interaction with his fellow-directors with suspicion and mistrust. The directors are entitled to rely upon the accuracy of the figures presented by the executive team in plans and budgets in the absence of identifiable issues which cause concern.

Delegation "up" also includes those cases where a "big character" dominates the board's decision-making. Where the board is so bamboozled by the dominant personality that they do little or nothing to consider the correctness of what is being done in their collective name, liability is likely to be decided on the same basis as a complete abrogation of responsibility. On the other hand, there are the credible fraudsters by whom certain directors are, not unreasonably, taken in: perhaps best exemplified by Madoff v Raven [2013] EWHC 3147 (Comm).

Coulda, woulda, shoulda…

Even if breach is established against the otherwise innocent director in any of the abrogation and delegation cases, questions of whether the loss would have occurred anyway are likely to arise.

"Whether it is open to the director to argue the counterfactual (i.e. the company would not have taken advantage of the opportunity) depends upon whether the transaction in question related to "existing trust property of the company":

- If it does, equitable compensation will be assessed on the substitutive basis so that the director cannot argue the counterfactual.
- If it does not, equitable compensation will be assessed on the reparative basis, so that the loss is assessed on the basis of what would have happened but for the breach of duty (for this distinction, see Davies v Ford [2023] EWCA Civ 167, and the first instance decision [2021] EWHC 2550 (Ch)).”

Even in cases of complete inactivity or advertent wrongdoing, two recent cases show that it does not follow that the director will be prevented from arguing the counterfactual.

Of the former type of case, in Dickinson v NAL Realisations (Staffordshire) Ltd [2018] BCC 506 (upheld on appeal [2020] B.C.C. 271) while the passive directors were liable for breach of duty for taking no part in supervising the company's affairs, it was held not to follow that this was causative of any loss. Their disengagement did not in any real sense enable the dominant director to misapply company funds. The Judge went on to hold that had the passive directors protested, the dominant director would have engineered their removal.

More strikingly still as a case of advertent wrongdoing (although only decided to the summary judgment standard) in Auden McKenzie (Pharma Division) Ltd v Patel [2020] B.C.C. 316 the Court of Appeal accepted that it was at least arguable that the director who had caused the misapplication of company funds to himself and his sister by the issue of sham invoices could defend on the basis that the company would be in precisely the same position if the payments had been made lawfully by the payment of dividends or bonus or other remuneration. The Court of Appeal noted that while a similar defence had been rejected by it in Bairstow v Queens Moat Houses Plc [2002] BCC 91 (usually cited in answer to similar counterfactual arguments), permission to appeal to the House of Lords had been granted before the case settled.

What these cases demonstrate is that even where breach of duty by a director for some degree of inactivity (whether total or partial, by delegation) is established, the question of whether the loss would have arisen anyway is not the dead duck it might once have appeared.