A Nelsonian eye is no help for directors in a Mexican stand-off

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The High Court of England has produced a reminder to directors that it is not prepared to restrict itself to a directors' tenure when considering if a director has acted in the best interests of a company but, rather it will consider the whole circumstances of a transaction and the director's roles.

In *LRJ Services Ltd (in liquidation) v Trew and ors,* the liquidators of the claimant company (**LRJ**) brought proceedings against its three former directors (**D1**; **D2**; and **D3**) for breach of duty to act in the best interests of LRJ. The Court was asked to consider, among other matters, whether the timings of directors' retirement and appointment affected their potential liability to the company.

The main assets held by LRJ were some trading subsidiary companies and a number of leaseholds of commercial units, including one of which was tenanted by another company (**LCF**) owned by D1 and D2.

In 2009, LCF defaulted on its obligations. At this time D1 and D2 were the only directors of LRJ. Shortly after LCF's default D1 and D2 resolved to enter into a restructure of LRJ's business.

The result of the restructure was:

- LRJ's subsidiaries were transferred to a new company (in which D1 and D2 had substantial shareholding). New Co also acquired LRJ's dormant subsidiaries and their valuable accrued tax losses.
- Various credit and debit balances between LRJ and other group companies were novated to New Co
- LRJ reduced its capital to £1 and paid a dividend of £21,317,726 to its parent company (which was also owned by D1 and D2). In order to make the dividend payment, D2 made a statutory statement of LRJ's solvency.
- The assets left in the LRJ were its leasehold premises. LRJ's ability to satisfy its obligations under the leasehold were dependent upon receiving rental payments from their tenants.

Soon after the restructure, LCF was again unable to pay its rent and defaulted on its lease. Shortly after this LRJ also defaulted and became insolvent.

The main thrust of the liquidators' argument was that at the time of making the solvency statement LRJ had insufficient assets or income to meet its liabilities.

It is the timing of the directorships in this restructuring that is of particular interest.

- D1 resigned during the course of the restructuring process but critically before the solvency statement was sworn by D2.

- D2 was a director throughout the process but stated he wholly relied on D1 and the internal LRJ accountants to prepare the financial documents relating to the reorganisation and confirmed that when swearing the solvency statement he considered if LCF was not able to make the payments it would be supported by another group company.
- D3 was only appointed as a director of the company during the restructuring process but after the solvency statement was sworn. His evidence was that he took no part in devising or implementing the reorganisation including solvency statement. Again, his evidence was that he relied on the work of D1 and D2 in putting into practice the restructuring steps following his appointment.

Therefore, whilst all of the directors denied the claims, by way of an alternative defence they were deploying a classic Mexican Stand-Off, each pointing the finger of blame at another.

Finally, D1 and D3 were seeking to avoid liability on the basis that they were not directors at the time the act complained of (the swearing of the solvency statement) was carried out.

However, the judge found that each of the directors had breached the duties he owed to LRJ to act in its best interests:

- D1 had prepared the financial documents, he knew or ought to have known that the restructure had insufficiently provided for LRJ's liabilities and that D2 was unlikely to change a course they had both determined would be taken. D1 therefore could not rely on the fact of his resignation prior to D2's swearing of the solvency statement.
- D2 was the director who swore the solvency statement. The judge held that D2 either failed to consider the information properly or his consideration that another company would assist LCF was fundamentally flawed for the purposes of signing off on the solvency statement.
- D3 had become a director mid-way during a multi-faceted restructure. He made no enquiries at the time of (or prior to) his appointment in order to satisfy himself that the steps he was taking upon his appointment were in the company's best interests.

In effect each director had applied a 'Nelsonian eye' to salient elements of the transaction and, having failed to properly consider the signals before them, were unable to avoid liability for breach of duty to the company, even D1 and D3 who were not directors at the time D2 had sworn solvency statement.

This case demonstrates that directors are not simply able to avoid liability by resigning or timing their appointment after a particular act.

Directors' duties to a company extend to the surrounding circumstances of their appointment and retirement, what they know to be taking place and the extent to which they should have made further enquiries.

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