

legal update

Your digest of recent chancery and commercial cases

IN THIS ISSUE

Misconduct and unfair prejudice - and divorces

Robin Hollington QC on
Grace v Biagioli and
Richardson v Blackmore

Trustee directors and trust companies

Mark Hubbard on
Re Poyiadjis

Disclosure in share sale agreements

Robert Levy on
Infiniteland Ltd v Artisan Contracting Ltd

Without prejudice ?

Emily Gillett on
Bradford & Bingley v Rashid

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Misconduct and unfair prejudice ~ and divorces

Grace v Biagioli and
Richardson v Blackmore

Robin Hollington QC

■ Introduction

Section 459 of the Companies Act 1985 provides statutory protection to minority shareholders on the grounds of unfair prejudice. The classic factual situation is that of a commercial joint venture between two shareholders, which begins in a spirit of mutual trust and confidence and ends in mutual recrimination and loathing. What the minority then usually wants is a court order that the majority shareholder buys his shares out, i.e. a corporate divorce. But the question then arises: to what extent should the court take into account any misconduct on the part of the minority? Or, to put it another way, is the minority to be penalised for having behaved badly? Obviously, in order to answer that question, one must ask the prior question: for what wrongdoing on the part of the majority is relief being claimed by the minority? For it is only in the context of that prior question that the issue of misconduct can be addressed.

The issue of misconduct has been recently considered in two Court of Appeal cases: *Grace v Biagioli* [2006] BCC 85 and *Richardson v Blackmore* [2006] BCC 276. But first, a little background from a different field.

■ An analogy with divorce?

It is interesting to compare the law of financial provision on marital breakdown. The family law context is, of course, quite different: the wife or husband seeking financial provision at the end of a marriage is not alleging that the other party has done anything wrong, but merely that the marriage has come to an end irretrievably. In contrast, in the context of section 459, the minority shareholder has to show that the majority has done something "wrong" (the word is used advisedly: it includes acting unconscionably according to traditional

equitable principles) and it is not sufficient that their relationship has simply broken down: see e.g. *O'Neill v Phillips* [1999] 1 WLR 1092 (HL). But there are some similarities. Marriage is a joint venture, which typically begins in a spirit of mutual trust between the partners and ends in mutual recrimination, and the court is concerned with the task of allocating the resources of the joint venture amongst the partners. In that field, the House of Lords has famously and recently ruled that, save in exceptional circumstances, the courts are not to take into account the conduct of parties, and in particular their respective responsibility for the breakdown of the relationship, in determining what financial provision ought to be made between the divorcing partners: *Miller v Miller; McFarlane v McFarlane* [2006] UKHL 24. As Baroness Hale said:

"It is simply not possible for any outsider to pick over the events of a marriage and decide who was the more to blame for what went wrong, save in the most obvious and gross cases".

In that case Lord Hoffmann expressly agreed with Baroness Hale. It is Lord Hoffmann who has been the most influential judge in recent years in the field of section 459. He gave the leading speech in *O'Neill v Phillips* (the leading case on section 459), in which, after emphasising the need for certainty, he held that a minority shareholder had to show that the majority had acted in breach of the bargain they had made between themselves, which extended to acting unconscionably according to traditional equitable principles. In an earlier case, in a similar vein to the passage cited above from the speech of Baroness Hale in the *Miller* case, he had said:

“[Section 459 petitions] often bear some resemblance to divorce petitions in the days before *Wachtel v Wachtel* [1973] Fam 72. Voluminous affidavit evidence is served which tracks the breakdown of a business relationship commenced in hope and expectation of profitable collaboration. Each party blames the other but often it is impossible, even after lengthy cross-examination, to say more than the petitioner says in this case, namely that there was a ‘clear conflict in personalities and management style’. It is almost always clear from the outset that one party will have to buy the other's shares and it is usually equally clear who that party will be. The only real issue is the price of the shares.” (See *Re XYZ Ltd* [1987] 1 WLR 102.)

This judicial sentiment, of not wishing to pry into the reasons for the breakdown in a relationship (marital or commercial), has not generally been applied in the context of section 459.

■ Misconduct

The classic statement of the significance of misconduct to claims for relief under section 459 is the dictum of Nourse J in *Re London School of Electronics* [1986] Ch 211. He held that the equitable doctrine of “clean hands” had no application because the remedy was a statutory one, but that misconduct of the petitioner could be relevant to the question whether the conduct of the majority was “unfairly prejudicial” to him.

■ *Grace v Biagioli*

Now we turn to the two recent Court of Appeal cases. Notwithstanding the dictum of Lord Hoffmann in the XYZ case quoted above, it is now well established that the courts will refuse relief to a minority shareholder who has by his own misconduct brought the expulsion upon himself. In *Grace v Biagioli* the petitioner had entered into

negotiations to purchase a related business, although they never came to fruition. His dismissal as a director was held to be justified by his willingness to embark on such negotiations without any prior disclosure or discussion with his fellow directors and shareholders and his attempts to conceal the existence of the negotiations by making statements that were untrue or became untrue and remained uncorrected. In other words, his misconduct was the principal cause of the breakdown of trust and confidence.

■ *Blackmore v Richardson*

In *Blackmore v Richardson* it was argued on the majority's behalf that the conduct of the minority shareholder in forging a letter in an unsuccessful attempt to influence negotiations between them for sale of their shares, and his concealment of the full circumstances of the forgery during the proceedings, precluded him from obtaining relief under the unfair prejudice remedy.

The majority arguments before the Court of Appeal were to the effect that, because of the forgery of the letter:

- (1) the relationship between the shareholders ceased to be that of quasi-partnership;
- (2) by analogy with the equitable doctrine of clean hands, the court should refuse relief; and
- (3) the court should refuse relief on the grounds of abuse of process.

Each of those arguments was rejected by the Court of Appeal. The leading judgment was given by Lloyd LJ.

On (1), it was held that the forgery did not automatically discharge the obligations of good faith. “There is certainly no basis for a finding that the good faith obligations were in some way discharged without any of the parties having had any choice in the matter.”

On (2), the majority had conceded in the court below (and did not seek to argue otherwise on appeal) that the law was as stated by Nourse J in *Re London School of Electronics*. Lloyd LJ noted that misconduct could,

depending upon the seriousness of the matter and the degree of its relevance, lead a court to refuse relief. He held that the cases on the clean hands doctrine in equity provided useful guidance by analogy. Applying that doctrine, he held that the “*forgery itself had no immediate or necessary relation to the circumstances upon which the petitioner's entitlement, or otherwise, to relief depended*”. At best it was an episode in the background history.”

On (3), Lloyd LJ held that the petitioner's misconduct and abuse of process was “neither sufficiently serious nor sufficiently closely related to the Respondents' unfairly prejudicial conduct to make it appropriate for the court to exercise its discretion so as to refuse [relief to the petitioner]”.

The Court of Appeal refused a late application by the majority for permission to appeal on the basis that the petitioner's shares should have been valued with a discount for a minority shareholding. It remains a moot point whether a court can reflect its disapproval of misconduct by reducing the price to be paid for the petitioner shares.

■ Conclusion

So the equitable doctrine of clean hands does apply by analogy in the context of section 459 petitions. Whilst the court does not sit so as to penalise parties for misconduct of which it disapproves, the misconduct will be relevant if it has an “immediate or necessary relation to the circumstances upon which the petitioner's entitlement, or otherwise, to relief depended”. It could, then, be said that, by ignoring some aspects of the minority's misconduct, the courts have partially incorporated the approach adopted in divorce cases. This approach, which is likely to shorten the time taken to hear section 459 petitions, is to be welcomed.

Robin Hollington Q.C. and Gerard van Tonder, both of New Square Chambers, appeared in *Richardson v Blackmore* [2006] BCC 276. Mark Hubbard, also of New Square Chambers, appeared in *Grace v Biagioli* [2006] BCC 85.

Trustee directors and trust companies

Re Poyiadjis



Mark Hubbard

In *Re Poyiadjis* 2004 WTLR 1169 (Isle of Man), which arose from the collapse of a US new technology company, assets held by BVI companies, owned in turn by Manx trusts, were under attack from a variety of US governmental and private claimants alleging fraud and worse. The trustees were also the directors of the BVI companies.

The trust deeds had the usual anti-*Bartlett* clauses excluding the trustee's duties to concern themselves in the management of companies in which the trust held a significant proportion of the shares. The clause was, no doubt, designed to circumvent the case law requiring such a trustee to take appropriate action, which "will no doubt consist in the first instance of enquiry of and consultation with the directors, and in the last but not most unlikely resort, the convening of a general meeting to replace one or more directors. What the prudent man of business will not do is to content himself with the receipt of such information on the affairs of the company as a shareholder ordinarily receives at annual general meetings. Since he has the power to do so, he will go further and see that he has sufficient information to enable him to make a responsible decision from time to time either to let matters proceed as they are proceeding, or to intervene if he is dissatisfied" (*Bartlett v Barclays Bank Trust Co. Ltd* (No.2) [1980] Ch 515).

In the course of an application by the BVI companies to use funds frozen by a restraint order made against the companies' bank accounts under the Manx equivalent of the Proceeds of Crime Act 2002, so as to defend litigation in the US, the companies argued that the funds were theirs and

theirs alone and the duties of the trustees as such in relation to the trust fund had no bearing on the issue before the court. The court made the following ruling on this issue:

"Whilst I accept that in law the bank accounts are corporate and not strictly trust assets, in the circumstances of this case, I find that the interposition of a limited company does not in any material way qualify the trustees' interest in the relevant bank accounts. It does not make a difference to the duties and responsibilities of the Trustees, including responsibilities to persons who have or may have an interest in the trust assets, whether held directly by the Trustees or through a company.

Further, in the circumstances of this case, the Directors, when exercising their powers including deciding what, if any, action to take relevant to the order, the bank accounts, or the in rem proceedings- cannot divest themselves of the knowledge and information obtained in their capacities as Trustees, and therefore must act at all times mindful of their duties and responsibilities to persons, who have, or may have an interest in the assets.

I therefore consider that to treat the companies as bodies independent of the Trustees qua trustees, and to treat the latter as shareholders, would be to ignore the reality of the situation. I further consider that, bearing in mind the terms of the order, and the circumstances which gave rise to it, the bank accounts ought to be considered not only as corporate assets but also as trust assets...".

The Deemster's words seem to raise rather more questions than they immediately answer and can be read as cutting boldly across such securely-

established principles as the division between shareholders' rights and the company's ownership of its assets.

When courts talk about the "reality of the situation" in contrast with what they acknowledge to be the result of applying the law to the facts, it is legitimate to ask what principles are being applied to discover this "reality" and why a court of law should be giving effect to anything other than that result.

The court's conclusion was that the trustees should justify the proposed use of the funds of the BVI companies to a judge who was not hearing the main proceedings as if on a *Beddoe* application. Perhaps a simpler and less controversial route to that conclusion might have been to say that the court had a discretion to make the order sought and so was entitled to take into consideration all the circumstances, including, if relevant, the identity of the shareholder of the company, and the relationship of the shareholder and the company to the facts relied on to obtain and maintain the restraint order.

Nevertheless, where trustees do hold companies on the trusts of the settlement and act as directors of those companies, which is a common situation in offshore structures, they need to be mindful of both the duties they owe to beneficiaries of the trust as trustees holding shares and the separate (and not necessarily identical) duties they owe as director to the company and, potentially, to the company's creditors.

Mark Hubbard and John Eidinow, both of New Square Chambers, were instructed by the BVI companies in the *Poyiadjis* litigation.

Disclosure in share sale agreements

Infiniteland Ltd v Artisan Contracting Ltd



Robert Levy

Vast amounts of time and energy go into the negotiation and drafting of share sale agreements, and in that process few issues are more contentious than the warranties offered by the seller.

The seller will want to offer as few warranties as possible (and combine that with a disclosure letter that is compendious and covers all areas of possible dispute). The buyer, on the

other hand, will seek extensive warranties, not only about the company's financial and fiscal affairs, but also about the state of its contracts, assets, premises etc. Standard-form

Disclosure in share sale agreements ~ continued

agreements contain numerous warranties and clauses seeking to place limitations on them, and provisions for the making of claims under warranties.

The recent decision of the Court of Appeal in *Infiniteland Ltd v Artisan Contracting Ltd* [2005] EWCA Civ 758 has caused something of a stir in this area. It suggests that extensive disclosure, even disclosure running to several volumes of materials, can drastically limit a buyer's ability to complain after completion, if the terms on which that disclosure is given are sufficiently well drafted.

The facts of *Infiniteland* were as follows. The parties were the buyer and seller of three companies under a share sale agreement. One of the companies, B, had an inflated operational profit as the result of an unusual one-off credit (in effect a cash injection) of £1,081,000 made to it by its ultimate parent company, which had been set off against B's cost of sales (the 'exceptional item'). The annual accounts admittedly failed to deal properly with this item, and they had been warranted as giving a true and fair view. Under the agreement, the seller had also warranted that save as set out in the Disclosure Letter the Warranties are true and accurate in all respects. A saving provision, clause 7.4, for the benefit of the buyer, provided that "the rights and remedies of the Purchaser in respect of any breach of the Warranties shall not be affected... by any investigation made by it or on its behalf into the affairs of [B] (except to the extent that such investigation gives the Purchaser

actual knowledge of the relevant facts or circumstances)...".

The buyer, *Infiniteland*, asserted that before the purchase it did not know about the exceptional item, and that accordingly there was a *prima facie* breach of warranty. It also asserted that its accountants, who had conducted due diligence prior to the agreement, had not actually discovered the exceptional item, and that, even if the item could have been discovered from the materials that had been disclosed under the disclosure letter, clause 7.4 did not preclude a claim for breach of warranty.

Park J found as fact that the buyer's accountant, J, understood the nature of the exceptional item in B's accounts and knew that its effect was that there was an actual operational loss as an apparent operational profit. As a result he dismissed the claim on the basis that, by virtue of clause 7.4, actual knowledge defeated *Infiniteland's* claim. He rejected the seller's argument that the matter had been adequately disclosed in the disclosure process.

All issues argued before Park J were live in the Court of Appeal. The Court of Appeal (by a majority) did not consider that actual knowledge on the part of the buyer's accountant of itself was attributable to the buyer and provided a defence to the claim by virtue of clause 7.4, but it found that there had been no breach at all. It held that, given the disclosure letter reference to a large number of documents that were made available to the buyer's accountant, the seller's disclosure did make adequate

disclosure of the rather unusual nature of B's profit and loss account. Critically, Chadwick LJ held (para 37 of his judgment) that the buyer's accountant did understand that the exceptional item was in effect a cash injection by the parent company to its subsidiary, *even if he did not fully understand the underlying reason why it had been made*. Given the wording of the disclosure letter, and its incorporation by reference of "all matters from the documents and written information supplied by us to your reporting accountants" this was adequate disclosure.

The House of Lords has since refused *Infiniteland* permission to appeal, so the Court of Appeal's decision remains, for the time being, the last word on the point. It follows that if a buyer accepts a clause providing for general disclosure of matters apparent from documents supplied to its due diligence team (or specified experts), then it is likely that there will have been adequate disclosure as long as the relevant matters came to the attention of the team or the expert, even if they were not passed on by the professionals to the buyer's decision-makers. This accords with commercial morality: if the seller discloses the essentials of a complex accountancy matter to the buyer's reporting accountant, the buyer should carry the risk of a breakdown in communication within its own team.

Robin Hollington QC and Robert Levy, both of New Square Chambers, appeared for the seller before both Park J and on the buyers' appeal to the Court of Appeal.

Without prejudice ?

Bradford & Bingley plc v Rashid



Emily Gillett

■ Introduction

In *Bradford & Bingley plc v Rashid* [2006] UKHL 37, the House of Lords, reversing the Court of Appeal, held that letters sent by a mortgagor to his mortgagee which referred to an "outstanding" amount were not privileged and constituted an admission of liability for the purposes of s. 29(5) of the Limitation Act 1980

('the 1980 Act'), even though they did not refer to any specific sum of money owed by the mortgagor to his mortgagee.

■ The facts

The appellants, *Bradford & Bingley* ("B"), had the benefit of a legal mortgage over Mr Rashid's ("R") home. R fell behind with the payments, the last being made in

January 1991. By October 1991, B had obtained a possession order and sold the property. However, a shortfall of approximately £15,500 remained for which R was personally liable. In 2001 B entered into correspondence with R seeking repayment. The case turned on the status of two letters written on behalf of R forming part of this exchange. The first of these two letters stated that R was "not in a

position to repay the outstanding balance, owed to [B]” but that he would “start to repay” when his finances were in order once again. B asked R for his proposals for repayment in response to which those acting for R wrote a second letter stating, “[R] is willing to pay approximately £500 towards the outstanding amount as a final settlement.” None of the correspondence was expressly marked “without prejudice”.

In June 2003, B issued proceedings to recover the £15,500 plus statutory interest. As his sole defence R contended that the claim was statute barred under s. 20 of the 1980 Act. The period of 12 years from the date of the last payment on account (3 January 1991) had already expired for the recovery of the principal sum secured by the mortgage. In response B argued that the statements in the letters, which were sent before the expiry of the twelve year period, amounted to acknowledgments under s. 29(5) of the 1980 Act.

■ The judgments below

At first instance, the Deputy District Judge held that the second letter was written without prejudice and was inadmissible. However, he found that the first letter did not benefit from any without prejudice protection and was admissible as a good acknowledgment under s. 29(5) of the 1980 Act. Consequently he gave judgment for B. On appeal, HHJ Hawkesworth QC found that both of the letters were written without prejudice and were inadmissible. On further appeal, the Court of Appeal ([2005] EWCA Civ 1080) unanimously upheld the judgment of HHJ Hawkesworth QC, finding that both letters benefited from without prejudice protection.

■ The House of Lords’ decision

Their Lordships ruled that the statements contained in the two letters were not caught by the without prejudice principle and that they amounted to acknowledgments for the purposes of s. 29(5) of the 1980 Act.

(a) *Were the statements caught by the without prejudice rule?*

Four of their Lordships (Lord Hoffmann dissenting on this issue) took the view that the statements contained in the two letters were not protected by without prejudice privilege (Lords

Hope (at [33]), Walker (at [39]), Brown (at [73]), and Mance (at [80])). They reasoned that as R had readily accepted liability to make the repayment to B, there was no dispute regarding liability which could be compromised. Nor was there any dispute as to the quantum of that liability, as at no point did R contest the outstanding amount that he owed to B. The only negotiations between the parties related to “when and to what extent [R] could meet the liability” he had readily admitted (per Lord Brown at [76]).

(b) *Were the statements acknowledgments?*

The House readily accepted that the statements constituted acknowledgments, affirming that an acknowledgment must merely be an admission of a legal liability on the part of a debtor or his agent to pay that which the claimant seeks to recover.

“But”, as Lord Hope put it (at [21]), “his acknowledgment need not identify the amount of the debt. ... [His] acknowledgment will be sufficient if the amount for which he accepts legal liability can be ascertained by extrinsic evidence”.

■ Analysis

(a) *The relevant policy objectives*

Their Lordships’ reasoning grappled with the public policies underlying, on the one hand, without prejudice privilege, and on the other hand, s. 29(5). Indeed the Court of Appeal came in for trenchant criticism for not having taken into consideration the latter. Lord Brown, for instance, thought that the Court of Appeal’s stance would lead to “a very substantial enlargement of [the] scope” of without prejudice privilege (at [72]). Rather, without prejudice protection must be tempered by consideration of the public policy underlying s. 29(5), namely that “a debtor who acknowledges his debt, and so induces his creditor not to have immediate resort to litigation, should not be able to claim that the debt is statute barred because the creditor held his hand” (per Lord Walker at [38]).

Thus, thought the majority, where there was no dispute between B and R as to R’s liability to pay the debt, the public policy rationale underlying the

without prejudice rule did not extend protection to communications discussing the repayment of that admitted liability. Discussions as to how repayment was to be effected did not amount to a compromise, but merely constituted a concession granted by B.

(b) *Cases where quantum remains in dispute*

However, in cases where the quantum remains in dispute, Lord Brown, with whom Lord Walker agreed (at [43]), was of the opinion that negotiations seeking to resolve this issue “should qualify for without prejudice protection”, notwithstanding the fact that they contained an acknowledgment under s. 29(5) of the 1980 Act (at [75]). He considered that where negotiations as to quantum existed “the policy underlying the without prejudice rule seems ... to outweigh the countervailing policy reason for lengthening the period in which the creditor must issue proceedings” (also at [75]). Lord Mance adopted similar reasoning, noting that for without prejudice privilege to apply “there must as a matter of law be a real dispute capable of settlement in the sense of compromise (rather than in the sense of simple payment or satisfaction)” (at [81]). Thus not all acknowledgments will fall beyond the protective reach of without prejudice privilege.

Therefore, if a legal adviser does not wish his communications to a mortgagee (or other creditor) to have the effect of constituting an acknowledgment, he should dispute liability or quantum in some manner. No doubt prudent legal advisers will raise such a dispute, even where it cannot realistically be argued, in an attempt to circumvent the House of Lords’ decision.

■ Conclusion

In summary, while the House of Lords’ decision succeeds in balancing the competing policy objectives of without prejudice privilege and acknowledgment, it remains to be seen whether legal advisers will be successful in circumventing their decision by raising bogus disputes as to liability and quantum.

Emily Gillett joined chambers in October 2006 on the successful completion of her pupillage.

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