

issue 3

serle quarterly

the newsletter of serle court



"Welcome to the latest edition of Serle Quarterly. This edition focuses on companies and limited liability partnerships and coincides with the publication of second editions of two works by members of Serle Court namely, Joffe on Minority Shareholders: Law, Practice and Procedure, and Whittaker and Machell on The Law of Limited Liability Partnerships.

Articles in this edition cover the use of Part 36 offers in directors' disqualification proceedings, early disclosure in unfair prejudice proceedings, a director's duty to disclose his misconduct, exit routes from LLPs and (on the back page) a comparison of English and US LLPs."

Victor Joffe QC

disqualification proceedings and part 36 offers

A director disqualified under section 6 of the Company Directors Disqualification Act 1986 ("the CDDA") will usually have to meet his own costs and those of the Secretary of State ("SoS"). This potential burden is a major concern, whether the director wishes to mount a full defence or merely wishes to challenge the length of the period of disqualification sought. Thus in practice, many directors with a bona fide case chose the cheaper option of submitting to disqualification, rather than risking an ultimately adverse costs order.

To what extent does CPR Part 36 "level the playing field"? By rule 2(1) of the Insolvent Companies (Disqualification of Unfit Directors) Rules 1987, the CPR apply to disqualification proceedings except where the 1987 Rules "make provision to inconsistent effect". Neither the 1987 Rules, nor the *Practice Direction: Directors Disqualification Proceedings*, make any provision inconsistent with the application of Part 36. Accordingly, it is open to a respondent director to make a Part 36 offer.

In *Re F & D Ltd* (2004, 19 May, Unrep.), despite the best efforts of the respondent directors (who drew no remuneration from the company) the company suffered severe trading difficulties and went into insolvent liquidation. But during the last year of its trading life, by

reason of the company's straightened financial circumstances, the respondents failed to ensure that it paid significant sums due to the Crown, primarily in respect of PAYE/NIC. Proceedings were brought against them under CDDA section 6, in which it was alleged that they had caused the company to trade when they knew that it was insolvent, and at the risk and expense of its Crown creditors. The ten-day letter under CDDA section 16 indicated that disqualification for nine years was appropriate, although this was subsequently reduced in correspondence to seven years. In any event, the SoS's position was that the case fell within the middle bracket identified in *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164.

Whilst accepting that they should be disqualified, the respondents argued that the period of disqualification intimated was excessive, and that in the circumstances of the case a period in the lower bracket only was merited. Shortly after commencement of proceedings, they made a Part 36 Offer ("the Offer"), the essential terms of which were that they would accept disqualification for four years, and pay the SoS's costs up to the date of acceptance of the offer if accepted within 21 days ("the cut-off date"). A full explanation of why the respondents considered four years to be appropriate was included within the



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Offer. At no time did the SoS seek clarification of the Offer. However, the Offer was rejected, and then the respondents served their substantial evidence.

Some weeks before trial, the SoS offered to accept a period of disqualification of four years as appropriate. But she declined to pay the respondents' costs incurred since the cut-off date, and sought payment of the majority of her costs. The respondents rejected this offer. Further costs were then incurred by both sides in preparation for trial.

At trial, the only substantive issue for decision was the length of disqualification. Moses J held that a period of three years was appropriate. The respondents then argued that since the SoS had failed to beat the Offer, although she should have her costs up to the cut-off date, she should pay their costs thereafter. The principal argument in response was that since the order of the Court demonstrated that the respondents

deserved disqualification, it was appropriate for them to pay the SoS's costs.

Moses J held (somewhat surprisingly) that, by rejecting the SoS's offer, the respondents had indicated that they did not accept that they should be disqualified; but the result of the case had shown that disqualification was appropriate. On the other hand, whilst the SoS had been entitled to take the view that the period contained in the Offer was inappropriate, she had in fact taken the view that it was appropriate, but only some months later. Having regard to the fact that the SoS was acting on behalf of the public, the appropriate way of dealing with the case, given the conduct of both parties, was to make no order for costs.

Absent the Offer, the respondents would clearly have been ordered to meet the SoS's costs. The fact that the SoS failed to beat the Offer not only in the event was the major factor relieving them of the liability for her

costs, but also enabled them to argue that they should have at least part of their own costs. On other facts (for example if the SoS declined to accept that the period offered was appropriate), such an argument might well succeed. The playing field may well be a little more level.



Victor Joffe QC who is one of the co-editors of Mithani: Directors' Disqualification, acted for the respondents in *Re F & D Ltd*

confessions of a delinquent director



When a director of a company is guilty of misconduct, is he under a duty to disclose his misconduct to the company of which he is a director such that he is liable for breach of duty if he does not so disclose? It seems that the answer is at least sometimes "yes", if not often so.

In *Item Software (UK) Ltd v Fassihi* ([2004] EWCA Civ 1244) the claimant company C had been distributing software products for company A. C sought to negotiate improved terms under its contract with A. Unbeknownst to C, F (a director of C) approached A with proposals for A to contract with a new company which F was creating to take over C's contract with A. F encouraged C to press A for improved terms under its contract. Ultimately, negotiations between C and A failed and A terminated its contract with C. The trial judge found that the negotiations between C and A failed because C insisted on terms which were unacceptable to A and that there was no evidence that C would have negotiated differently if F had not encouraged C (thus there were causation difficulties with respect to the allegations of diversion and sabotage of business). However, he also found that had F informed C of his misconduct then C would have accepted A's proposals instead of insisting on its own terms.

The Court of Appeal held that in the circumstances F was under a duty to disclose his misconduct to the company and the trial judge was correct in finding that F acted in breach of his duties and was therefore liable for damages. The Court of Appeal found there to be good policy reasons to impose such a duty and that there was no authority to the contrary

(distinguishing *Bell v Lever Bros* [1932] AC 161). The application of *Bell v Lever* has now been further limited and several questions have been left unresolved in relation to the ambit of that authority.

In her judgment in *Item*, Arden LJ based her reasoning for the imposition of the super-added duty to confess upon an application of the duty to act *bona fide* in the best interests of the company. She declined the invitation to find an independent duty imposed on fiduciaries to disclose misconduct or to disclose information of relevance and concern to the company. The court was not substantively extending the duties of directors, but merely recognising a duty which makes the remedy for an existing liability of a director to account for secret profits and for the diversion of corporate opportunities more effective.

This is perhaps a rather odd application of the duty to act *bona fide* in the company's best interests, imposing as it does a positive duty to disclose to the company. The broader impact of the decision remains to be seen, but certainly there will be significant opportunity to allege a further breach of duty against delinquent directors.



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Timothy Collingwood frequently acts for companies, shareholders and directors in relation to breaches by directors of their duties

equality of arms for minorities

The scenario is a common one. The minority shareholder (P) is unhappy at how the MD is managing the company. The MD, as majority shareholder, ensures the dissentient shareholder's removal from the board – thereby drastically limiting his access to information about the management of the company. P presents a petition under section 459 of the Companies Act 1985. He is aware of potentially unfairly prejudicial conduct by the MD and suspects that this is merely the tip of the iceberg. How can he make good his case? And how, without having to incur the bulk of the costs of a full trial (or perhaps two separate trials) on liability and quantum, can he find out how much his shares are worth?

Proper and early disclosure is crucial for P. His right to a fair trial bestowed by Article 6(1) of the ECHR is key, because this includes the right to equality of arms. This requires each party to be afforded a reasonable opportunity to present his or her case under conditions which do not place him or her at a substantial disadvantage vis-à-vis their opponent: see *De Haes and Gijssels v Belgium* (1998) 25 EHRR 1.

If P sues a fellow shareholder who is also a director of the relevant company, the right to equality of arms demands that if potentially relevant company documents are available to the defendant director, they should also be

available to P. The need to ensure equality of arms can lead to disclosure even being ordered of relevant company documents to which legal professional privilege attaches, provided that they do not relate to hostile litigation between P and the company.

Equality of arms can also be prayed in aid to enable P to obtain advance disclosure of documents enabling him to value his shareholding. It cannot be right that the MD is in a position to make a CPR Part 36 payment at the outset of proceedings but P is not in a position properly to value the company (and hence his shareholding in it) and so to make a CPR Part 36-complaint offer (and obtain the potential advantages that flow from it) until after disclosure (or, where a split liability/quantum trial has been ordered, after disclosure prior to the second, quantum, trial).

In order to achieve equality in procedure the court can require a party to provide his opponent with early information to enable the latter to make a realistic Part 36 offer to settle (or to respond to such an offer): see *Gnitrow Ltd v Cape plc* [2000] 1 WLR 2327 (CA). A further reason for advance disclosure so as to enable P to value his shares is to enable a mediation to take place at any stage of proceedings without his being at a disadvantage. This is in accordance with the court's duties pursuant to CPR Part 1.4(2),

when furthering the overriding objective by actively managing cases, of encouraging ADR and helping the parties to settle the case.

A recent example of the application of these principles is *Arrow v Edwardian Group Ltd* [2004] EWHC 1319 (Ch), where the court ordered advance disclosure from the company "to enable the Petitioners to make a realistic Pt 36 offer or engage in meaningful mediation".



Daniel Lightman appeared for the petitioners in *Arrow v Edwardian Group Ltd*

commercial divorce

Subject to the terms of an LLP agreement, a member of an LLP has a right to cease to be a member by giving reasonable notice to the other members (LLP Act 2000, s 4(3)). However, the LLP legislation does not include any express default provision as to the financial consequences of cessation. In the absence of an agreement between the members, the only option available to a member wishing to leave, and to realise his share in the LLP, may be to petition the court pursuant to CA s 459 for an order that the other members acquire his share or pursuant to IA s 122(1)(e) for an order that the LLP be wound up.

Under s 459, relief cannot be granted unless there is unfairly prejudicial conduct on the part of the other members. A petition pursuant to s 459 is unlikely to succeed if the member merely wishes to leave and the majority have simply refused to purchase his share. In *O'Neill v Phillips* [1999] 1 WLR 1092 Lord Hoffmann held that the jurisdiction under s 459 does not extend to 'no fault divorce'. Lord Hoffmann's analysis is likely to be applied to LLPs. The position is, however, far less clear in relation to just and equitable winding up. In *Re Guidezone Ltd* [2001] BCC 692 Jonathan Parker J held that the just and

equitable winding up jurisdiction was no wider than the jurisdiction under s 459 in the sense that, if the conduct of the respondent is not unfair for the purposes of s 459, it cannot support a petition on the just and equitable ground. This finding is surprising and would appear to be inconsistent with prior company and partnership case law. The statutory jurisdiction to wind up an LLP on the just and equitable ground is, prima facie, broader than the jurisdiction under s 459 in the sense that a finding of unfairly prejudicial conduct is not a statutory prerequisite to the making of a winding up order: all that is required is that it is just and equitable in all the circumstances. Although a court may be unlikely to make a winding-up order merely because the petitioner wishes to realise his investment (even if his desire to leave has caused an irretrievable breakdown in relations), there may well be circumstances in which it would be just and equitable to make a winding up order in the absence of unfairly prejudicial conduct on the part of one member.

It is not easy to predict how the courts will approach petitions by members of LLPs. The courts will inevitably be influenced strongly by the law relating to companies and

partnerships. That said, the courts will, within the s 459 and s 122(1)(e) framework, have to resolve the difficulties arising from the grant of a statutory right to members to cease to be members, but the omission from the legislation of provisions dealing with the financial consequences of such retirement. Unless the courts are willing to exercise the powers under ss 459 and 122(1)(e) either to require the other members to purchase the outgoing member's share or to order a winding up, a member who wishes to leave will have a stark choice: either he continues as a member until such time as agreement can be reached or he gives notice and ceases to be a member and thereby possibly forfeits his share.



John Machell frequently acts for departing partners, shareholders and members of LLPs

English and US limited liability partnerships

Limited liability partnerships originated in the United States, in the aftermath of the savings and loan crisis of the 1980s, which resulted in many claims being made against accountancy and law firms. The first LLP statute was enacted in Texas in 1991. Today, all US states have LLP legislation.

LLPs were introduced into English law by the Limited Liability Partnerships Act 2000, which (together with extensive regulations made under it) came into force in April 2001. There is a similarity of name; but is an English LLP the same animal as a US LLP? The answer is No: there are important distinctions.

An English LLP is a body corporate, and as such (and like a company) it is a legal entity separate from its members. Like the directors of a company, the members act as the agents of the LLP. Their personal liability for the corporation's debts and liabilities is (generally speaking, and subject to issues of assumption of personal responsibility) limited to what they agree to contribute towards a shortfall on a winding up. In this respect, their position is similar to that of the members of a company limited by guarantee. Part of the price for this protective shield for the members (and corresponding limitation of rights of recourse for those doing business with the LLP) is that the LLP must meet certain disclosure requirements, in particular the filing of "true and fair" annual accounts in the same way as a company. An English LLP differs fundamentally, therefore, from a traditional partnership in English law, which

is neither a corporation nor any other form of separate legal entity, and in the business of which each individual partner acts as the agent of the other partners.

Unlike English LLPs, US LLPs are not corporate bodies, but are general partnerships which have elected, under their chosen state law, to have the status of a "limited liability partnership". This election is generally effected by the partnership simply filing an application and paying a fee. Most states require the application to be renewed annually. No state requires the filing of accounts as the price for this (although most require a minimum amount of insurance to be carried). Some states (those which have adopted the Uniform Partnership Act 1994: 'RUPA') provide that a general partnership, although not a corporation, is nevertheless a legal entity distinct from the individual partners. (The Law Commission has recently proposed this for English partnerships.) The existence of this separate legal personality does not, however, relieve individual general partners from their normal unlimited liability. In those states where the law gives to a general partnership separate legal personality, the LLP which that general partnership elects to become will similarly have separate legal personality. Whether or not a US LLP has separate legal personality may well be a central factor for English law if called upon to determine whether it will recognise the limitation on personal liability of the partners which the LLP's domestic state law enacts.

That limitation on personal liability differs from state to state, in particular as to whether it extends to cover general commercial debts and liabilities of the partnership. But it appears to be the position that all US states will shield an individual LLP partner from vicarious liability for the negligence or misconduct of others in the partnership (provided that he was not himself personally involved), and equally that all US states will hold an LLP partner personally liable for his own misconduct or negligence, or for the misconduct or negligence of those under his direct supervision or control. In this respect, and owing to the separate corporate status of an English LLP, the position of a US LLP member differs from the position of an English LLP member (to the latter's advantage).



John Whittaker advises on partnership matters and LLPs

chambers: news

The theme of this newsletter, companies and limited liability partnerships, has been chosen to coincide with the publication of two books by members of chambers. Victor Joffe QC, David Drake and Giles Richardson have completed the second edition of their book "Minority Shareholders: Law, Practice and Procedure" which was published by Butterworths at the beginning of October. The royalties have been donated to charity. John Whittaker and John Machel have also completed the second edition of their book "The Law of Limited Liability Partnerships" which will be published by Jordans in December.

Earlier this year we were pleased to be invited to sponsor the Society of Asian Lawyers seminar "The Fight Against Terrorism: Killing Human Rights?" which took place on 22nd September 2004. The seminar was chaired by Kuldip Singh QC and featured a number of well-known speakers including Shami Chakrabati, Director of Liberty.

The Legal 500 directory was published in September and five members of chambers have received new recommendations this year, bringing the total number of individual recommendations to 46.

We are pleased to be able to announce that two more members, Victor Joffe QC and Patrick Talbot QC, have become CEDR accredited mediators bringing the total number of mediators in chambers to nine.

Finally, we are delighted to be sponsoring the Lincoln's Inn Chapel Lunchtime Concerts, this year. These concerts take place on Tuesdays fortnightly at lunchtime (1pm), require no booking and are free to attend. We will put details of the concerts on our website news page and would be delighted if you would like to join us.