SHARE SALE FRAUD – spreading the net

This session looks at the issues arising for shareholders where there has been fraud by one or more of them in selling their company. What evidence will the defrauded purchasers be looking for to show the agency of the fraudsters or an assumption of responsibility by their fellow shareholders with deeper pockets? Whose guilty knowledge must be shown? And what sort of disclosure issues are likely to arise?

A workshop led by Rupert Reed QC, David Drake and Jonathan Tickner

Background facts

1. Arthur has retired from a career in banking. Having watched Dragons' Den and Shark Tank, he is very keen to help young entrepreneurs by investing small amounts of seed capital and giving them strategic advice in growing their businesses.

2. One such entrepreneur is Brandon, a university friend of Arthur's son. After graduating from college in London, Brandon built a business selling the advertising and marketing rights of media celebrities to businesses. Keen to 'take his business to the next level', Brandon approached Arthur for an investment. Arthur agreed to provide £50,000, but for a 10% share in the company, Brandon Talent Ltd ('BTL'), and a seat as a non-executive director. That 10% stake was held by a family investment company controlled by Arthur, Uther Holdings Ltd ('UHL'); but in many ways the outward impression Arthur gave was that he treated the shares as his own.

3. All seemed to go well. Arthur called Brandon every couple of months and was told of new clients that Brandon had signed. Brandon was never strong on documents or figures, and suggested that Arthur could inspect those at BTL's office in Soho. Arthur did not attend any Board meetings or review any of BTL's documentation.

4. In early 2016, Brandon rang Arthur to tell him that he had started talking to two leading US advertising agencies, Global Advertising LLC ('GAL') and Heroic Advertising LLC ('HAL') about a sale of the business for USD10m, and to request Arthur's help in 'doing the deal'. There followed three meetings with GAL's management team that Arthur attended. At each of those meetings, Brandon gave detailed information in respect of BTL's clients, book debts and financial position.

5. At the first meeting in May, which was at Brandon's club in Shoreditch, Arthur joined Brandon in meeting GAL's CEO, Chuck, for lunch. There was no detailed discussion. Arthur made clear that he had a non-executive role, but had great confidence in Brandon and his business. He also made clear that he was looking to tag along in selling UHL's shares, but possibly remain as a consultant or advisor to BTL.

6. At the second meeting in June, which was at BTL's offices in Soho, Arthur again joined Brandon and Chuck for lunch prior to an intended meeting between them to negotiate some heads of terms. At the end of the lunch Arthur explained that he would be leaving

it to Brandon to deal with the detail of the sale and left the meeting. That evening he sent an email in which he expressed pleasure at the prospect of working with Chuck and his team in the future.

7. At the third meeting in July, Arthur accompanied Brandon to a meeting at GAL's offices on Broadway in New York attended by GAL's senior management, GAL's lawyers, Innovative Law LLP, who were tasked with legal due diligence, and a firm of accountants, Dan Drax LLC ('DDL'), retained by GAL to carry out commercial and financial due diligence on BTL. Arthur introduced Brandon's presentation of a number of PowerPoint slides which detailed, among other things, BTL's key clients and headline financial figures. After the presentation, Arthur thanked Brandon encouraging GAL to ask them any questions arising out of the presentation.

8. While in New York in July, Arthur and Brandon also attended a meeting with the other prospective purchaser, HAL, at its offices in Tribeca. They were joined at that meeting by another angel investor in BTL, Archie, who like Arthur had no detailed knowledge of BTL's affairs. Again, Arthur introduced and attended the presentation, but because Brandon had 'lost his voice', it was given by Archie.

9. There followed some months of negotiations between BTL, GAL and HAL and between their respective firms of lawyers. Finally, on New Year's Eve, the parties signed a Sale and Purchase Agreement (the 'SPA'), by which GAL and HAL each agreed to purchase 50% of the shares in BTL, and each of Arthur, Archie and Brandon gave warranties.

10. In a corporate reorganisation in the run up to the transaction, UHL's shares in BTL were transferred to a newly incorporated subsidiary, Morgana Le Fay Ltd ('MFL'), so that MFL ended up being the vendor of the shares controlled by Arthur – MFL was represented for the brief period from its incorporation to execution of the SPA by solicitors Galahad LLP.

11. Arthur, who had planned to execute the SPA for MFL, was away on holiday; but he had in advance arranged for Brandon to sign for MFL, on the basis of a power of attorney.

12. MFL received USD 1m for its shares, and Arthur was paid USD 1m shortly afterwards in accrued back-pay from UHL, from funds distributed to it by MFL. Arthur spent much of the USD 1m on a luxury holiday to Bhutan and gave the rest to his children in post-graduate education.

13. In January, GAL discovered that Brandon had lied to them about BTL's list of clients, its lucrative contracts with three of those clients and the receivables of USD 2m due from those clients. Without those book debts, BTL was substantially balance sheet insolvent. Further researches showed that all of the email addresses given by Brandon for those clients were fictitious and used recently registered domain names that were similar to the domain names of well known companies. Those companies have each confirmed that they had discussed but never made contracts with BTL.

14. Brandon has disappeared, and his emails have been deleted from his webmail account. Arthur, meanwhile, has stepped down from UHL, gifting his shares to his children; its

shares in MFL have been distributed to them in specie. UHL does not appear to have any significant assets; it is not clear that MFL has any either. The UHL email account Arthur used is controlled by another UHL subsidiary, Sir SML Ltd ('SML'); neither he nor MFL Ltd have any right to access the account.

15. GAL seeks legal advice. It claims to have lost around USD6m, being both the USD5m it paid under the SPA, as well as USD1m in related financing and legal costs. It accepts that Arthur was not himself complicit in any fraud. However, given that Arthur has significant UK assets, including various properties in Pimlico, and that Brandon has disappeared, they are keen to recover all of their losses from Arthur.

16. *HAL* also seeks legal advice in relation to a claim for similar amounts in respect of its purchase of the other 50% of the shares in BTL. It accepts that it had no direct communications with Arthur and that its only meeting with him was at the meeting in Tribeca in July.

Questions

A. What claims may GAL have against *Arthur*?

B. What about a claim against MFL?

C. Can GAL get disclosure of material from Arthur's email account?

D. How would those claims be made by reference to each of the Shoreditch, Soho and Broadway meetings?

E. How might GAL seek to show its reliance on the presentation?

F. What claims may *HAL* have against Arthur?

G. Would you advise GAL to consider seeking a summary determination?

H. Is this all unfair on Arthur? Does that matter? What arguments can GAL advance in seeking to mitigate any potential unfairness?