

ENGLAND AND WALES / JUDGMENT

Stainer v Lee & Ors

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Neutral Citation Number: [2010] EWHC 1539 (Ch) IN THE HIGH COURT OF JUSTICE CHANCERY DIVISION Case No: HC09C04660 Royal Courts of Justice Strand, London, WC2A 2LL Date: 29 June 2010 Before : THE HON MR JUSTICE ROTH

- ----- Between : ROBIN STAINER

- and -

(1) GERARD ALAN LEE

(2) ENRIQUE ELLIOTT

(3) ELDINGTON HOLDINGS LIMITED Applicant Respondents

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- ----- Mr Edward Davies (instructed by Clapham & Collinge) for the Applicant Mr Barry Isaacs (instructed by Jaswal Johnston) for the First and Second Respondents Mr Tom Sprange (instructed by Steptoe and Johnson) for the Third Respondent
Hearing dates: 9 June 2010

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Judgment

Mr Justice Roth : 1. 2. This is an application under section 261 of the Companies Act 2006 (“the Act”) for permission to continue a derivative claim seeking relief on behalf of Kerrington Limited (“the Company”) against its two directors, Mr Gerard Lee and Mr Enrique Elliott, and Eldington Holdings Limited (“Eldington”). The application is brought by Mr Robin Stainer (“the Applicant”) who has a small shareholding amounting to about 0.08% of the Company’s issued share capital. On 15 December 2009, I made an order on the papers under section 261(3) for the application to be served on the Respondents and the Company and on 8 March 2010 directions were given by consent for the service of evidence. This is accordingly the substantive hearing of the application under section 261(4). In summary, the Applicant contends that the two directors are in breach of their duties by reason of the circumstances surrounding the lending of very substantial sums of money by the Company to Eldington, a company of which Mr Lee is the sole shareholder and director. Mr Lee, directly and through Eldington, now owns some 87% of the issued shares of the Company. The complaints concern the terms on which those loans were made and, as regards part of the monies, the fact that the loans were made at all. As regards the lending that is subject

to the latter complaint, on the basis that the knowledge of Mr Lee is attributable to Eldington, it is alleged that Eldington holds that money as constructive trustee for the Company and so should repay it to the Company.

Background

3. 4. 5. 6. The Company was incorporated in November 1985 and its business is property investment and development. Mr Lee has been a director throughout, and is described as the moving force behind the Company. Mr Elliott has been a director since 11 December 2000. In about 1988, the Company made an offer of shares to raise finance as a business expansion scheme, which offer attracted over 100 small investors. By about December 2000, the total issued share capital was 12,757,642 ordinary 50p shares, of which about 20% were held by Mr Lee. On 27 November 2000, an offer was made by Eldington to acquire all the shares in the Company, other than those already held by Mr Lee, at a price of 90p per share. Eldington was incorporated on 19 September 2000 and was described by its solicitor, Mr Sprange, in the hearing as a special purpose vehicle, effectively established for the purpose of this acquisition. As mentioned above, it has been owned and controlled throughout by Mr Lee. As a result of acceptances of its offer, Eldington acquired 62.69% of the issued share capital by 31 March 2001, and subsequent acquisitions took its shareholding as at 31 March 2002 up to 65.58%. As a result, the combined holding of Eldington and Mr Lee was then a little over 85% of the issued share capital of the Company. In order to fund its offer, as stated in the offer document, Eldington arranged a facility with the Royal Bank of Scotland plc ("RBS") of up to £6.2 million. Interest was payable on monies borrowed under the facility at a rate of 2% per annum over the RBS base rate. As at 31 March 2001, the amount borrowed by Eldington from RBS appears to have been £4,345,379, and there may have been (the position is unclear on the evidence on this application) further drawing on the facility in the following year of some £300,000. However, by 31 March 2002, Eldington's liability to RBS was entirely, or almost entirely, discharged, since its total bank borrowing, including under the facility, is shown in its accounts as reduced to £5000. The discharge of Eldington's liability to RBS was achieved by a loan made by the Company to Eldington. On 5 March 2001, Mr Lee wrote to the shareholders in the Company referring to the Eldington offer and informing them that the Company will enter into a loan agreement with Eldington and that, as this would constitute the giving of financial assistance for the acquisition of shares in the Company, this would require approval by special resolution at a general meeting. Although neither a copy of the notice calling such a general meeting nor the minutes of the meeting were in evidence, it appears (and is not a subject of challenge by the Applicant) that such a meeting took place and that the so-called "whitewash" procedure of the Act was duly followed. What is material is the form of loan agreement that was approved. This appears from Mr Lee's statutory declaration filed on 9 May 2001 on Form 155(6)a, which refers to the loan agreement between the Company and Eldington and states: "The rate of interest applicable to the loans shall be the rate of interest agreed between the Company and [Eldington] or, in the absence of such agreement, the rate payable by [Eldington] under a

facility letter between [Eldington] and the Royal Bank of Scotland plc.” Mr Lee’s declaration also states that the amount of cash to be transferred to Eldington is up to £7 million. 7. 8. 9. One of several curious features of this case is that, despite making three witness statements, Mr Lee has not produced a copy of this agreement (“the Original Loan Agreement”). However, Mr Lee states that on 9 July 2001, Eldington borrowed £4,679,901 from the Company and it is common ground that such borrowing was pursuant to the Original Loan Agreement. Subsequently, the Company and/or its subsidiaries advanced substantial further sums to Eldington such that the total lending as shown by the accounts as at 31 March each year has been as follows: Date Total owed by Eldington to the Company and/or its subsidiaries 31 March 2002 31 March 2003 31 March 2004 31 March 2005 31 March 2006 31 March 2007 31 March 2008 £4,863,206 £6,534,924 £6,834,642 £6,950,482 £8,075,607 £8,101,322 £8,105,725 However, prior to the commencement of these proceedings, no interest was ever paid by Eldington on this borrowing. Indeed, the annual accounts of the Company for the years 2002/03 through to 2007/08 included a statement as regards the loan to Eldington that: “The loan is repayable on demand and is interest free.” That prompted a query from one of the minority shareholders (a Mr Woolfe) addressed to Mr Lee on 1 December 2003: “At present I find it difficult to understand how such a loan can be in the interests of the shareholders of Kerrington Limited. I note that you are the sole shareholder of Eldington Limited, and it would appear that the loan benefits you in your capacity as that shareholder, rather than the 34% minority holders of shares in Kerrington Limited. I shall be glad if you will let me know the circumstances of the loan, and what factors were taken into account in making that loan.”

10. Mr Lee replied on 4 December 2003: “It was clearly stated in Eldington’s offer document in December 2000 that monies would be lent to Eldington interest free. Obviously the necessary EGM’s were called and resolutions passed. Shareholders were advised in the offer document by the independent director to accept the offer, especially if it went unconditional, to avoid being a minority shareholder in a private company. However, the board has decided for future years interest will be accrued on outstanding monies loaned to Eldington.” 11. 12. In fact, the offer document makes no reference to the loan being interest free. Moreover, the accounts for the years following this letter do not accrue interest but continue, as I have mentioned, to state simply that the loan (in increasing amounts) is interest free. Some four years later, on 3 March 2008, the Applicant wrote to Mr Elliott, referring to the increasing size of the interest-free loan to Eldington as set out in the accounts and to Mr Lee’s interests in Eldington. The letter asked: “I would be grateful if you would explain the business rationale for this interest free loan. In particular, I would like to know why the interests of the minority shareholders are better served by continuing with the loan, rather than demanding that it be repaid.” 13. The reply came from Mr Lee, by letter dated 12 May 2008 in which he stated: “We have consulted our auditors prior to replying to you, and we have been advised that we should not enter into discussions regarding individual the company’s accounts with shareholders.” 14. 15. 16. 17. There followed correspondence in which the Applicant raised the prospect that there appears to have been

a fraud on the minority but asked for an explanation as to why that view may be mistaken; alternatively he asked if Mr Lee wanted to make an offer for his shares. The response was simply an offer to buy the Applicant's shares at 40p, which led to a brief exchange of letters from the Applicant as to why the price should be higher and from Mr Lee declining to increase his offer. It was against that background and following a detailed solicitors' letter that the Applicant commenced these proceedings. The original Particulars of Claim contended, in outline, that the directors were in breach of their duties to the Company

- (a) in allowing the lending to Eldington to be on an interest-free basis and (b) in lending further sums to Eldington after 31 March 2002 ("the additional lending") for some purpose other than discharging or reducing liability incurred for the acquisition of shares, which purpose had not been approved by the members and was not in the Company's best interests. The claim also relies on the fact that at all times the Company had a very substantial level of bank borrowing at commercial rates of interest, such that the monies loaned to Eldington could otherwise have been used to reduce or discharge the Company's bank debt. It is further alleged that the lending to Eldington has been funded by the Company's borrowings from banks at commercial rates of interest. In bringing that claim, the Applicant received express support in the form of letters from 35 other minority shareholders who also made a financial contribution to the costs. Subsequent to the initial ruling that the papers be served on the respondents, there have been three developments. First, on 10 March 2010 the claim was amended to allege that Eldington is a constructive trustee for the Company as regards the monies received by way of the additional lending and should provide an account and repayment of those monies to the Company. 18. Secondly, by his first witness statement of 31 March 2010, Mr Lee stated: "I was advised by the Company's auditors, a tax charge would arise on the income in the hands of the Company. It has always been my intention that interest would be paid on the loans, either when Eldington sold its shares in the Company or when the assets of the Company were realised on a liquidation." 19. 20. He proceeded to say that the Company has now been advised by its auditors that no tax is payable on any interest received since Eldington now owns more than 75% of the shares of the Company so that group tax relief is available and that on or before 19 April 2010 Eldington would pay the Company the sum of £3,598,097.06, representing its auditors' calculation of the sum of annual simple interest at 2% above the RBS base rate. In fact, only £750,000 was repaid by Eldington prior to 19 April 2010. Mr Lee's 2nd witness statement (of 2 June 2010) does not explain why the 19 April date was not met but states that £1 million was paid on 27 May 2010 to Fletchergate Limited, ("Fletchergate") a wholly owned subsidiary of the Company; that as at 1 June 2010 the Company owed him personally a little over £1.725 million, "which sum has now been credited in the Company's books as having been repaid to me and then used to repay the interest"; and that on 2 June 2010 Eldington repaid the Company a further £199,000. He exhibits a letter from the Company's auditors that confirms these payments, although that letter states that the payment of the £1 million to Fletchergate was made by "an independent third party" and, it seems, not by Eldington. Thirdly, on 19 April 2010, the directors called an extraordinary general meeting of the Company for the members to

consider a resolution authorising a new loan agreement between the Company and Eldington. The meeting was held on 21 May 2010 when votes were cast by proxy by 55 shareholders (aside from Mr Lee and Eldington) holding between them 174,500 shares, and the resolution was passed by a majority representing just over 80% of the votes cast (excluding Mr Lee and Eldington). A loan agreement in the form approved was then entered into on 24 May 2010 ("the New Loan Agreement").

21. Mr Lee exhibits to his 2nd witness statement an executed copy of the New Loan Agreement. The recitals are as follows: "(A) On 9th July 2001, the Lender and the Borrower entered into an Agreement pursuant to which the Lender made a loan to the Borrower of the sum of £4,679,901 ("the Original Loan") together with interest at a rate to be agreed between the parties, or alternatively, at the rate of 2% per annum over the base rate of Royal Bank of Scotland plc. (B) Since 19th July 2001, the Lender has made various further loans to the Borrower totalling £3,431,220 ("the Further Loans"). (C) The Borrower has paid the Lender all outstanding interest up to and including 2nd April 2010 on the Original Loan and the Further Loans. (D) The Borrower and the Lender have agreed to enter into this Agreement to ratify and confirm the terms upon which the Original Loan and the Further Loans are loaned by the Borrower to the Lender." 22. Clause 3 of the New Loan Agreement contains the following provisions for payment of interest: Until the Loans are repaid in accordance with the "3.1 provisions of this Deed, the Borrower shall pay interest to the Lender (less any tax which the Borrower is required by law to deduct or withhold from such payment) on the Loans. Interest shall be payable annually in arrears on 31st 3.2 March of each year. 3.3 Interest shall be payable at the rate of 2% per annum above the base rate of Royal Bank of Scotland PLC on the Original Loan and 1.2% per annum above the base rate of Royal Bank of Scotland PLC on the Further Loans." 23. 24. On 1 June 2010, just over a week before the hearing of this application, Mr Lee signed a personal letter to the Company, expressed to be in consideration of the Company entering into the New Loan Agreement, guaranteeing the payment by Eldington of all monies owing under the New Loan Agreement. Derivative claims The jurisdiction governing derivative claims in England and Wales is now comprehensively governed by Chapter 1 of Part 11 of the Act: sections 260-264. Such claims may be brought only under the provisions in that chapter or pursuant to a court order in proceedings on an "unfair prejudice" petition under section 994: section 260(2). Under section 261, a member of a company who brings a derivative claim must apply for leave to continue it, and on that application if the evidence does not disclose a prima facie case, the court must dismiss it: section 261(2). As stated above, the present application passed through that stage when I gave directions for service on the Company and the Respondents. 25. The second stage, being the hearing of the application, is governed by section 263. This provides, insofar as material: "(2) Permission (or leave) must be refused if the court is satisfied-
- (a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, or

- (b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
- (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission-
 - (i) was authorised by the company before it occurred, or (ii) has been ratified by the company since it occurred.
- (3) In considering whether to give permission (or leave) the court must take into account, in particular-
 - (a) whether the member is acting in good faith in seeking to continue the claim;
 - (b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
 - (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be-
 - (i) authorised by the company before it occurs, or (ii) ratified by the company after it occurs;
 - (d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;
 - (e) whether the company has decided not to pursue the claim;
 - (f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.
- (4) In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.” 26. Accordingly, section 263(2) requires the refusal of permission in certain circumstances, but there is no corresponding provision as to the circumstances in which permission must be granted. The statute instead sets out a series of factors which, if the mandatory refusal does not apply, the court must then take into account in deciding whether or not to grant permission. Sub-sections 263(2)(a) and (3)(b) cross-refer to section 172, which provides: “(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —
 - (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,

- (d) the impact of the company's operations on the community and the environment, the desirability of the company maintaining a (e) reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.
- (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
- (3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.” 27. As several judges have pointed out, there are many cases in which some directors, acting in accordance with section 172, would consider it worthwhile to continue a claim, at least for the time being, whereas others, also acting in accordance with section 172, would take the opposite view: see Warren J in *Airey v Cordell* [2007] BCC 785, 800; Mr William Trower QC in *Franbar Holdings Ltd v Patel* [2009] 1 BCLC 1, 11; and Lewison J in *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) at [85]. In *Iesini*, Lewison J noted some of the factors which a director, acting in accordance with section 172, would take into account in reaching his or her decision (at [85]): “They include: the size of the claim; the strength of the claim; the cost of the proceedings; the company's ability to fund the proceedings; the ability of the potential defendants to satisfy a judgment; the impact on the company if it lost the claim and had to pay not only its own costs but the defendant's as well; any disruption to the company's activities while the claim is pursued; whether the prosecution of the claim would damage the company in other ways (e.g. by losing the services of a valuable employee or alienating a key supplier or customer) and so on. The weighing of all these considerations is essentially a commercial decision, which the court is ill- equipped to take, except in a clear case.” 28. 29. Lewison J held (at [86]), following Warren J and Mr Trower QC, that the mandatory bar in section 263(2)(a) will apply “only where the court is satisfied that no director acting in accordance with section 172 would seek to continue the claim. If some directors would, and others would not, seek to continue the claim the case is one for the application of section 263(3)(b). Many of the same considerations would apply to that paragraph too.” I respectfully agree, and shall apply that test. As regards the standard to be applied generally under section 263, Lewison J held that something more than simply a *prima facie* case must be needed since that forms the first stage of the procedure; and that while it would be wrong to embark on a mini- trial the court must form a view on the strength of the claim, albeit on a provisional basis: see at [79]. It seems to me possible, with respect, that the court might revise its view as to a *prima facie* case once it has received evidence and argument from the other side, so the antithesis between section 261(2) and 263 may not be so stark. But in any event, I consider that section 263(3) and (4) do not prescribe a particular standard of proof that has to be satisfied but rather require consideration of a range of factors to reach an overall view. In particular,

under section 263(3)(b), as regards the hypothetical director acting in accordance with the section 172 duty, if the case seems very strong, it may be appropriate to continue it even if the likely level of recovery is not so large, since such a claim stands a good chance of provoking an early settlement or may indeed qualify for summary judgment. On the other hand, it may be in the interests of the Company to continue even a less strong case if the amount of potential recovery is very large. The necessary evaluation, conducted on, as Lewison J observed, a provisional basis and at a very early stage of the proceedings, is therefore not mechanistic. The present application 30. 31. As stated in paragraph 15 above, the Applicant seeks to claim in respect of two aspects of the directors' conduct: (a) lending to Eldington on an interest-free basis; and (b) the making of the additional lending to Eldington. The directors' conduct in both of those respects is alleged to constitute a breach of their fiduciary duty and, as from 1 October 2007 (when this provision came into force), a breach of their duty under section 172. However, as the considerations which arise are not the same as regards those two aspects, it is appropriate to consider them separately.

- (a) The interest- free lending It seems clear that the authorisation by the Company at the EGM on 30 March 2001 was for the Company to lend to Eldington under a loan agreement specifying that interest would be at a rate agreed between the Company and Eldington or in default at of such agreement at 2% above the RBS base rate: see paragraph 6 above. There is no suggestion by Mr Lee in his evidence that any other rate was agreed. And there is no explanation whatever as to why the Company's accounts then stated, year on year, that the loan was interest free. Moreover, in his reply to Mr Woolfe of 4 December 2003, Mr Lee did not controvert Mr Woolfe's assertion that the loan appeared to have been made interest-free. On the contrary, he made the completely inaccurate statement that the Eldington offer document had said that the loan would be interest free. He also stated that the board had decided that interest for future years would be accrued on the outstanding monies lent to Eldington, but that also did not happen in 2004/05, 2005/06, 2006/07 or 2007/08. Then in the accounts for the year ended 31 March 2009, there appears for the first time a statement that the Company and Eldington "have an agreement in place whereby no interest is payable on the outstanding loan on an annual basis, however, at the settlement date the [C]ompany is owed a return of a minimum of compounded interest at 3% per annum from the date of the initial loan plus a margin on the return earned by Eldington..." 32. In his first witness statement in these proceedings of 31 March 2010, Mr Lee made the statement quoted at paragraph 18 above that he had always intended that interest would ultimately be paid. There he suggested that interest was not paid only because the Company had been advised that a tax charge would arise on income in the hands of the Company and that as Eldington "now" owns more than 75% of the shares in the Company such that group tax relief is available, interest accordingly would be paid. 33. No explanation whatever is given as to the inconsistency between these statements and what Mr Lee had said to Mr Woolfe, or indeed the recurrent statement in the 34. 35. 36. 37. Company's accounts (until the 2008/09 accounts) that the loan was entirely interest free. Moreover, the 75% shareholding threshold was reached at least by 31 March 2009, but no steps were then taken to collect interest prior

to the commencement of these proceedings. In the absence of sight of the Original Loan Agreement, it is not at present clear whether it was entered into with the provision for interest as authorised by the Company – such that the Company then failed to collect interest; or whether it was entered into on an interest free basis as stated in the accounts – such that it was not within the terms authorised at all. But whatever proves to be the true position, it seems to me that failure to obtain interest over a period of almost 9 years on lending to Eldington that rose from £4.6 million to £8.1 million constitutes very strong grounds for a claim that the directors were in breach of their fiduciary duties. Indeed, no real answer to that allegation was offered in the evidence or argument on behalf of the Respondents. The answer given on this application is that since the commencement of these proceedings, a sum amounting to the outstanding interest has been paid, with the final instalment indeed paid just a week before the hearing. In the light of the tax charge that would have arisen if the interest had been paid annually at RBS base plus 2%, it is said that the Company has suffered no loss. There was dispute before the Court regarding the figures, with no less than five different approaches to computation of loss being presented on behalf of the Applicant and the first two Respondents. Accurate assessment of the tax position depends on what loss may have been suffered by the Company in particular years for the purpose of off-setting, and the amount of tax that would have been payable on interest if the interest had been paid annually. The Applicant contends that with the payments now made, the Company has still lost some £950,000. The Respondents dispute this. I note that in his first witness statement, Mr Lee said that Eldington will now pay interest to the Company in the amount of £3.598 million. When that figure was disputed in a witness statement from the Applicant as insufficient, Mr Lee by his second witness statement of 2 June 2010 said the Company was being repaid some £3.66 million on account of interest. In my view, it is not appropriate to reach a final conclusion on the figures on an application of this kind. I refused the Respondents permission to file evidence from the Company's accountants with a further schedule of calculations produced the day before the hearing on the ground that this was much too late. Where a Company has what appears to be a very strong case of breach of duty but it is unclear whether all the resulting loss has now been repaid, it is in my judgment appropriate for that case to proceed at least as far as disclosure so that a more accurate view can be reached as to the quantum of loss. More specifically, applying the tests in section 263(2)(a) and (3)(b), it cannot be said that no director acting in the Company's best interests would seek to continue the claim; on the contrary, I consider that many such directors would consider that it is important to continue it in the light of the events that have happened.

38. Moreover, what has occurred gives good grounds for careful scrutiny (to put it at its lowest) as regards the financial dealings between Eldington and the Company. The repayments on which the Respondents rely include the sum of £1 million paid to Fletchergate from a source that has not been identified. Why interest owed by Eldington to the Company should be discharged by a payment from someone else to the Company's subsidiary is altogether unclear. It is therefore appropriate, in the 39. 40. interests of the Company, to determine

whether this was indeed a payment on account of the interest from Eldington or pursuant to some other transaction.

- (b) The additional lending As regards this head of claim, it also seems clear that lending to Eldington for a purpose other than to discharge the loans it incurred for the purchase of the Company's shares is outside the scope of the authority granted by the members of the Company by special resolution on 30 March 2001. Indeed, the Respondents did not seek to suggest the contrary. For the directors, Mr Isaacs sought to argue that the amount lent under that authority was in fact very substantially more than the £4.68 million borrowed by Eldington on 9 July 2001, on the basis that the total amount paid by Eldington for the shares in the Company was about £7.24 million. However, that is controverted by the terms of the New Loan Agreement. As appears from recital (D) thereof, that agreement was to "confirm" the terms upon which what are referred to as the "Original Loan" and the "Further Loans" were made; and only an "Original Loan" of £4.68 million is stated to have been made under an "Agreement" which provided for a default rate of interest of RBS base plus 2%. That is the basis on which interest on the additional £3.43 million lent to Eldington is treated in its entirety as "Further Loans" for which a rate of only RBS base plus 1.2% is agreed in clause 3.3. I also note that Mr Lee, who is of course fully conversant with the facts, does not suggest in his witness statements that more than £4.68 million was borrowed by Eldington for the purpose of funding its purchase of shares in the Company. Accordingly, I conclude that, as alleged by the Applicant, the additional lending was indeed in the amount of £3.43 million. A company may of course lend money to its parent or to another company in which a director has an interest if its articles so permit, and here the Company's articles contain such authorisation, provided that this interest is disclosed to the Board at the meeting where the transaction is considered: paras 122.6 and 122.7.1 I note that no Board minutes have been produced showing a decision by the directors to make or approve the large additional sums progressively lent to Eldington. But in any event, the Applicant alleges that there is no discernible basis on which such lending here could be in the Company's interests. 41. Only in his 2nd witness statement of 2nd June 2010 does Mr Lee address the purpose of the additional lending, although the allegation that this lending served no legitimate purpose and was not in the best interests of the Company is set out in the original Particulars of Claim. Mr Lee disputes that allegation and states: It is commonplace for companies within the same "9. group to support each other. In the present case, the loans have benefited the group as a whole, and this benefits all of [sic] members of the group. Indeed, I have personally made substantial unsecured and interest-free loans to the Company over the years as is evident from the balance which stood to my loan account as at 1st May 2010. In addition, Eldington has given security by way of a cross-guarantee of the Company's obligation to its bankers, a copy of which is at pages 6 to 9 of GAL2. In addition, and as stated in paragraph 19 of my first 10. witness statement, the interest paid on the loans is more than the return which would have been earned if the monies 1 As the Company ceased to be a public company in 2001, the provisions of section 200 regarding loans to "a person connected with a director" do not apply. 42. 43. 44. 45. advanced were placed in a bank

account or prudently lent elsewhere.” In my judgment, that falls far short of explaining the purpose of the additional lending or why it was thought to be in the Company’s best interests, given that this has been put directly in issue. There is no indication whatever of why Eldington needed £3.43 million or indeed what it is using the money for. Since Eldington does not appear to carry on any business, and was described by its own solicitor as a special purpose vehicle formed to acquire the shares in the Company, the rationale is entirely obscure. Since at the time of the advances the additional lending was stated in the Company’s accounts to be interest free, it is difficult to see how the obtaining for the Company of an attractive rate of interest can have been the justification. Even with the money that has now been paid on account of interest, as Mr Davies for the Applicant pointed out, whether or not a rate is attractive depends upon the nature of the borrower and the risks involved. The lending to Eldington has at all times been wholly unsecured. Bearing in mind Mr Lee’s evident conflict of interest as both a director of the Company and the sole shareholder and director of Eldington, one would expect some clear evidence as to the rationale of the arrangements and indeed some contemporary documentation as to the Company’s decisions to make these successive, substantial advances. Accordingly, on the information currently before the court there appears to be at least a well arguable case that the additional lending to Eldington was made in breach of the directors’ relevant duties. However, in answer to this part of the claim the Respondents rely strongly on the New Loan Agreement and the approval which that received from a majority of the members voting, excluding the shareholding of Mr Lee and Eldington. I do not consider that the New Loan Agreement constitutes a ratification of the breach within section 263(2)(c)(ii). Although the agreement uses the word “ratify” in recital (D), it determines a rate of interest that does not correspond to the rate which applied when the lending was made (which was either interest free, as stated in the contemporary accounts; or at RBS base plus 2%, which is the basis on which the payment on account of interest to date has been computed). Effectively, it is a new agreement between the Company and Eldington to govern the terms on which Eldington may continue to borrow the monies for the future. On that basis, the Respondents contend that no purpose is served by this derivative action. A director having regard to his duties would not seek to continue it, and the vote at the meeting approving the New Loan Agreement shows the views of the members who have no interest in the additional lending (i.e. excluding Mr Lee and Eldington), which is a matter to which the court must have “particular regard” under section 263(4). I accept that it is relevant to take into account the New Loan Agreement and the vote at the meeting. However, the underlying claim is that the additional lending was in breach of the directors’ duties and that, on the basis of a constructive trust, Eldington holds the monies so advanced to the account of the Company and should be ordered to repay them. This gives rise to two considerations. First, were the members given a fair and candid explanation of the purpose of the New Loan Agreement which they were being asked to approve in the EGM on 21 May 2010? Secondly, as regards the resolution at this meeting, were they informed of Mr Lee’s interest in Eldington? The notice calling the meeting was not in evidence. All that Mr Lee says with regard to it is that an EGM was called “in order for the members to consider, and if thought fit, pass a

resolution that the Company enter into a loan agreement with Eldington on the terms set out in the draft attached to the notice convening the meeting.” The New Loan Agreement followed the form of that draft. 46. 47. 48. The notice evidently did not set out the purpose for which Eldington sought the loans since I was told that this remains unexplained. There is also nothing to suggest that it informed the shareholders of Mr Lee’s interest in Eldington. I consider that it is well arguable that the fact that the shareholders had been informed of this at the time of the March 2001 EGM cannot be sufficient (indeed some of the shares may have changed hands in the interim), nor that reliance can be placed on the fact that the Applicant had sent the independent shareholders a copy of his Particulars of Claim in these proceedings. In summary, I am by no means satisfied that the shareholders voting by proxy in favour of the resolution approving the New Loan Agreement can be said to have given informed consent, that is to say that they received a notice giving information that satisfies the principles established by *Kaye v Croydon Tramways*

[1898] 1 Ch 258 and *Pacific Coast Coal Mines v Arbuthnot* [1917] AC 607. If the resolution were vitiated on this ground, the entry into the New Loan Agreement may itself be contrary to the Company’s best interests for the same reason as applied to the additional lending at the outset, and the promotion of that agreement may be a further breach of the directors’ duties under section 172. I do not attach much weight to the fact that Mr Lee has signed a letter giving a personal guarantee to the Company of Eldington’s borrowing. Even assuming that letter is contractually binding (the New Loan Agreement was concluded on 24 May 2010 whereas the letter is signed only on 1 June and there is no reference to the guarantee in the agreement), Mr Lee has given no information whatever as regards his personal means to support that guarantee. Faced with that dearth of evidence, Mr Isaacs could rely only on the fact that Mr Lee’s assets included his ownership of some 80% of the Company which, on its balance sheet for 31 March 2009, had equity of £11.9 million. However, assuming again in the Respondents’ favour that Mr Lee’s shareholding is unencumbered, a significant part of the Company’s assets is accounted for by the very debt to it from Eldington of £8.1 million of which Mr Lee is guaranteeing repayment. Furthermore, as Mr Lee has himself pointed out, there is “no liquidity in shares of a private company.” Although Mr Lee’s majority shareholding is obviously of value, it is by no means clear to what extent it would be sufficient to satisfy the debt (including interest) from Eldington. Altogether, it is difficult at this stage for the court to reach a clear view as to the strength of the case under this head. However, the sum involved is very significant. The Respondents submitted that even if the New Loan Agreement could itself be set aside, the directors of the Company could decide to make another loan to Eldington on an equivalent basis. I am not impressed by that argument. If the proceedings continue such that Eldington was subject to a claim that it held the monies as constructive trustee for the Company, it seems to me that directors acting in good faith to promote the success of the Company for the benefit of the members as a whole may well decide not to make a fresh loan in that amount to Eldington, especially at a time when the Company itself has a substantial borrowing from its own banks (amounting to over £45 million in loans and

overdraft as at 31 March 2009). I give weight to the fact that the costs of proceedings are likely to be significant, but given the size of this head of claim, I consider that here too it is very unlikely that no director acting in accordance with his duties under section 172 would seek to continue the claim; on the contrary, I find that such a director is likely to regard it as important to continue the claim at least beyond the present stage. Other considerations

49. My findings above are not, however, the end of the matter since the Respondents allege that the Applicant is not acting in good faith, within the terms of section 263(3) (a). Pointing to the correspondence in which he sought a purchase of his shares, and the small amount by which he would personally benefit from the claim, it is said that his original motive was to get a better price and that he is now pursuing a vendetta against Mr Lee for failing to offer one. I reject that submission. Read as a whole, it seems to me clear that the Applicant's point in his initial letter was to determine what was going on and to protect his interest as a minority shareholder. It was only when his inquiry was brushed off that he raised as an alternative that if Mr Lee was not prepared to explain how the Company's activities benefited the minority shareholders then he would rather sell his shares. That seems to me entirely understandable. Furthermore, it is clear that the Applicant commenced these proceedings not only in his own interests but for the benefit of a large number of minority shareholders. As stated above, he secured letters of support and a financial contribution from 35 other small shareholders. There have been significant developments since they gave that initial support, and while the Applicant cannot be criticised for failing to go back to them since those developments are so recent, I consider that it would be inappropriate in the circumstances to give weight to those expressions of view under section 263(4) for the purpose of the decision on permission now. But I do regard the Applicant's conduct in seeking and obtaining that support as strong evidence that he was acting in good faith. 50.
51. The Respondents also contend that this is a case that the Applicant could pursue by an "unfair prejudice" petition under section 994, and thus in his own right, which is a relevant consideration under section 263(3)(f). As Lewison J observed in *Iesini*, the availability of the alternative remedy is included under sub-section 263(3) not 263(2) and is accordingly a discretionary consideration not an absolute bar. In many cases, an allegation of breach by directors of their fiduciary duties could found an unfair prejudice petition as well as a derivative action. But that should not disguise the fundamentally different nature of the two forms of proceedings. As Millett J explained in *Re Charnley Davies Ltd (No 2)* [1990] BCLC 760 at 784: "The very same facts may well found either a derivative action or a s [994] petition. But that should not disguise the fact that the nature of the complaint and the appropriate relief is different in the two cases. Had the petitioners' true complaint been of the unlawfulness of the respondent's conduct, so that it would be met by an order for restitution, then a derivative action would have been appropriate and a s [994] petition would not. But that was not the true nature of the petitioners' complaint. They did not rely on the unlawfulness of the respondent's conduct to found their cause of action; and they would not have been content with an order that the respondent make restitution to the company. They relied on the respondent's unlawful conduct as evidence of the manner in

which he had conducted the company's affairs for his own benefit and in disregard of their interests as minority shareholders; and they wanted to be bought out. They wanted relief from mismanagement, not a remedy for misconduct.” 52. In the present action, the Applicant is not seeking to be bought out. He commenced these proceedings, with the support of 35 other minority shareholders, seeking financial remedies for misconduct against the two directors personally, and now an order for restitution from Eldington. Such orders could not be made on an unfair prejudice petition, albeit that the court could by way of remedy authorise the bringing of proceedings in the name of the company by the petitioner: section 996(2)(c). But that would then give rise to a subsequent and further set of proceedings. I consider 53. 54. 55. that given what is at the heart of the present case, a derivative action is entirely appropriate and therefore the theoretical availability to the Applicant of proceedings by way of an unfair prejudice petition is not a reason to refuse permission. The remaining factors listed under section 263(3) are of little relevance here. Sub-section 263(3)(c) does not apply. Given that I have held that the New Loan Agreement does not constitute ratification of the additional lending, I do not think that there is likely to be further action constituting such ratification within sub-section 263(3)(d). And as for sub-section 263(3)(e), the Company has not formally decided not to pursue the claim and, in any event, the two directors constituting the board of the Company would hardly be likely to commence a financial claim against themselves and against Eldington which one of them owns. Eldington For Eldington, Mr Sprange sought to persuade me that I should reach a different view as regards his client on the basis that the claim against that company is weaker and would add nothing to the claim against the two directors. However, it is only as against Eldington that a claim lies for repayment of the additional lending as money had and received. Inclusion of Eldington as a defendant therefore makes a very significant practical difference to the remedy and I consider that it is appropriate for it to be included. Accordingly, I shall grant permission for the derivative claim to continue, but subject to some control. First, I shall limit that permission to the conclusion of disclosure, at which stage the Applicant, if so advised, must apply for further permission. By that stage, the facts and strength of the case will be much clearer. Secondly, I shall impose terms as to costs, pursuant to section 261(4): see below. Indemnity as to Costs 56. The Applicant seeks an indemnity for his costs, relying on *Wallersteiner v Moir* (Mo

- 2) [1975] 1 QB 373. I think that is clear authority that a shareholder who receives the sanction of the court to proceed with a derivative action should normally be indemnified as to his reasonable costs by the company for the benefit of which the action would accrue. But where the amount of likely recovery is presently uncertain, there is concern that his costs could become disproportionate. Accordingly, I place a ceiling on the costs for which I grant an indemnity for the future (i.e. excluding the costs of the present application) at £40,000 (exclusive of VAT). There will be liberty to apply to extend the scope of that indemnity.

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