This article was first published in Greens Business Law Bulletin, Issue 167 (published August 2020) and on http://www.westlaw.co.uk. It is reproduced here with the kind permission of Thomson Reuters.

****

Director's breach of fiduciary duty and unfairly prejudicial conduct

Prescott v Potamianos (Re Sprintroom Ltd) [2019] 2 B.C.L.C. 617

Andrew Bowen *QC*

Introduction

Re Sprintroom Ltd had an unusual twist that raised some novel issues for the Court of Appeal. The first instance judge had given judgments in two separate sets of proceedings: an action by a company, SE Ltd, against Dr Potamianos ("Dr P") in respect of software intellectual property rights created by him; and a s.994 petition by Dr P as minority shareholder in a company, S Ltd, claiming that the affairs of S Ltd were being carried on by the majority shareholder, Mr Prescott ("Mr P"), in a manner unfairly prejudicial to the interests of Dr P and seeking an order for the purchase of his shares at a reasonable price. Although the appeal was only against the decision on the s.994 petition, the facts in the intellectual property claim and a finding of a breach of duty by Dr P were the foundation for the main issues in the appeal.

The facts

SE Ltd made motor drives. Both Mr P and Dr P were directors and provided their services to SE Ltd via "service companies"; in Dr P's case, BD Ltd. The first instance judge noted that this was motivated by tax avoidance objectives since Dr P had been recruited personally and the use of the service company was a mere tool for tax purposes. Dr P was a specialist software creator who developed the software underlying SL Ltd's digital drives. In 2007 Dr P acquired a 40 per cent holding in SE Ltd while Mr P had the remaining 60 per cent; they also made a shareholders' agreement governing their participation in the business. In 2012 S Ltd was incorporated as a holding company for SE Ltd; both Mr P and Dr P transferred their shares in SE Ltd to S Ltd and received in return 60 per cent and 40 per cent shareholdings, and directorships, in S Ltd respectively. New staff were appointed by SE Ltd who were described as "the succession team".

The dispute between the parties started in 2014 when both Mr P and Dr P began to discuss the reduction of their day-to-day involvement in the management of SE Ltd and succession planning by way of recruitment of a new management team. During these discussions Mr P became concerned that Dr P had sole access to the source code for the software and wanted security for future software support. By 2016 the dispute over the source code had become toxic. The source code files had been "hidden" by Dr P in domains on the server of which only he knew the location and to which he was not prepared to give other staff access. Mr P asked that the source code be made available to a newly recruited software programmer and the judge found that Dr P then acted in a manner not "direct, frank or remotely helpful" in refusing access, and also used his unique knowledge of the source code to gain an advantage for himself in his dispute with Mr P that was contrary to his fiduciary duties owed to SE Ltd. As a result Dr P was effectively sidelined from further management decisions. His solicitors rather elegantly notified Dr P that exclusion from management when participation was part of the bargain between shareholders, and where such exclusion was not justified, was inequitable conduct. Mr P had offered to buy out Dr P on four separate occasions but these offers had been refused.

In April 2017 Dr P was removed as a director of SE Ltd and in June 2017 SL Ltd issued its claim to the source code. In September 2017 Dr P issued his s.994 unfair prejudice petition.

First Instance

The judge upheld SE Ltd's source code claim although he accepted that Dr P had had good grounds to defend the action. On the s.994 petition he held that both SE Ltd and S Ltd were quasi-partnerships in which both Mr P and Dr P were entitled to participate in management with the corollary that equitable considerations rendered it unfair for Mr P as the majority shareholder to use his voting power to exclude Dr P the minority shareholder from management (*O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1102) because each played a significant part in the day-to-day running of the business of both companies which were run informally and on the basis of trust and confidence. The judge said that, as a result, the starting point was that it was inequitable for Mr P to use his voting power to exclude Dr P from participation in management without giving him the opportunity to remove his capital on reasonable terms.

The crucial and controversial finding made by the judge was that Dr P had been in breach of his fiduciary duty because when SE Ltd asked how it could access the source code, Dr P had not been entitled to act in a manner that was detrimental to SE Ltd by being evasive or misleading since he should have provided a candid statement of his position and he behaved as he did because he alone knew what source code had been created and where it was stored and had that knowledge because of the trust placed in him by SL Ltd. However, because he had been entitled to defend the source code claim, he should have been excluded from participation in management only in relation to the source code and that his conduct was not so serious as to justify his exclusion from all management and subsequent removal as a director. The judge upheld the complaint of unfair prejudice and ordered Dr P's shares to be valued at full pro rata value without a discount, subject to Mr P's argument that, because his offers to buy out Dr P's shares were made on fair and reasonable terms, their rejection was unreasonable and the petition should be dismissed. The judge held that there was insufficient evidence to determine that issue and to decide whether the petition should succeed and he ordered a second hearing on that issue and on the proper value of the shares.

Mr P appealed against the finding of unfair prejudice and the valuation at full pro rata value; Dr P appealed against the judge's decision to order a second hearing to determine whether the offers were fair and reasonable.

Court of Appeal

The crux of Mr P's complaint was that, having found that Dr P had been in breach of his fiduciary duty to S Ltd in his conduct in the face of SE Ltd's claim to the source code, the judge ought then to have concluded that he was not entitled to relief on his unfair prejudice petition since his behaviour brought to an end the relationship of trust and confidence underlying the quasi-partnership prior to his exclusion. In a combined judgment of McCombe, Leggatt and Rose LJJ, the court noted that the appeal was against the judge "evaluative" decision on unfairly prejudicial conduct and not against any of his primary factual findings.

In dismissing Mr P's appeal, the court said that it should only interfere with the judge's conclusion on "unfair prejudice" if he had exceeded the "generous ambit within which reasonable disagreement is possible", in light of the guidance in *Assicurazioni Generali Spa v Arab Insurance Group* [2003] 1 W.L.R. 577 where at [16] Clarke LJ said that some conclusions of fact were not conclusions of primary fact but involved an assessment of a number of different factors weighed against each other, sometimes called an evaluation of the facts on which different judges could legitimately differ and which were closely analogous to the exercise of a discretion. At [76] the court summarised that on a challenge to an evaluative decision of a first instance judge the appeal court had to ask whether the judge's decision was wrong by reason of some identifiable flaw in the treatment of the question to be decided such as a gap in logic, a lack of consistency or a failure to take account of some material factor that undermined the cogency of the conclusion. At [81] the court held that it could not identify any flaw in the judge's evaluation from the primary facts that justified interfering with his conclusion that Mr P had not been entitled to exclude him from management altogether. At [82] the court noted that it had been referred to a number of authorities where a breach of duty had justified exclusion from management but observed that there was no rule of law to that effect and was always a question of fact and degree.

On the issue of whether the "buy-out" order should be at full pro rata value or at a discount, the court noted that the judge had followed the guidance of Lord Hoffmann in *O'Neill v Phillips* [1999] 2 B.C.L.C. 1 at [16] that the value should represent an equivalent proportion of the total issued share capital without a discount for it being a minority holding, so no error of principle could be identified. The court rejected Mr P's argument that valuation should be at a discount because Dr P had acquired his shares at a discount, holding that he had not been a mere investor but actively involved in management, at [90].

The court agreed with Dr P that the judge ought to have decided the issue of whether the offers to buy out Dr P's shares had been made on fair and reasonable terms, and allowed his appeal. It held at [140] that there was sufficient material to establish that the rejection of the offers did not defeat his petition by making his exclusion fair and that an expert valuation had not been necessary to make that decision.

Conclusion

Re Sprintroom Ltd illustrates again the difficulty of challenging an evaluative decision at first instance and provides clear guidance on the generous discretion afforded to the courts to determine whether a minority shareholder has been unfairly excluded even where that same shareholder has been in breach of fiduciary duty owed to the relevant company. The decision also emphasises that for any offer to purchase to be potentially fair and reasonable it must allow the minority proper access to relevant company documents or provide that a mutually acceptable independent expert will have similar access.