SHERIFF APPEAL COURT

[2016] SAC (Civ) 8
XO19/16

Sheriff Principal M W Lewis
Sheriff N Morrison, QC
Sheriff Principal B Lockhart

OPINION OF THE COURT
delivered by SHERIFF PRINCIPAL M W LEWIS

In the cause

LOUISE WITTER, Residing at 8 Rosebank Place, Aberdeen

Applicant and Appellant;

Against

QHSE SOLUTIONS LIMITED, 5 Oldcroft Road, Aberdeen

Objector and Respondent:

Act: McLean, Advocate; instructed by Laurie & Co LLP, Aberdeen
Alt: Logan, Advocate; instructed by Lindsay & Kirk, Aberdeen

9 September 2016

[1] Louise Witter applied to the Sheriff Court in Aberdeen under section 266 of the Companies Act 2006 ("the 2006 Act") for leave to raise derivative proceedings on behalf of QHSE Solutions Limited ("the Company") against Gregor Gibb. The application, which was opposed by the Company, was refused and appeal has been taken against that decision.

Background

[2] The Company was incorporated in 2002 and its principal business involved the provision of health and safety training services and chemical legislation compliance advice to businesses operating primarily in the oil and gas, the chemical and the transport sectors of the industry. The Company had an issued share capital of £2, comprising two £1 shares. Ms Witter and Mr Gibb each own one share. The Company has two directors: Ms Witter and Mr Gibb. Mr Gibb is the Company Secretary.

[3] In or around 2007 the business relationship between Ms Witter and Mr Gibb began to falter. She decided to withdraw from day to day involvement in the Company but did not do so at that time. Ms Witter contended that she and Mr Gibb had agreed that they would sell the business in 2010. That did not happen. She also contended that they had reached an agreement on the terms upon which she would leave the Company. This contention was disputed by the Company. For the purposes of this appeal it was agreed by parties that she ceased to have day to day involvement in the management of the Company from about 3 March 2010 by which time she had already formed another company - Chemical Legislation Professionals Limited ("CLPL"). CLPL was incorporated on 20 January 2010. She has not resigned as a director of the Company nor has she sold her share (Document 5 in the appendix to the appeal print).

[4] Mr Gibb continued to operate and manage the Company. Ms Witter had access to the Company's bank accounts, and still receives copies of the bank statements. She maintains that in order to deny her access to Company funds, Mr Gibb set up a system of transferring money from the Company's bank accounts into his personal bank account and when necessary to pay outstanding invoices, he made counterbalancing payments into the Company's bank account. He also submitted invoices to the Company for payment for his

services, which were paid by the Company. Ms Witter regards these transfers and payments as unjustified. Expelidor Limited was incorporated on 25 July 2011. It subsequently changed its name to Aquaterra Ventures Limited. Mr Gibb is a director of this company. On 05 August 2011 Expelidor Limited entered into an agreement with the Company under which the Company transferred ownership of its training materials to Expelidor Limited for a nominal consideration of £1. By the end of March 2012, the Company ceased trading.

Legislative framework

[5] Section 265 defines the circumstances in which derivative proceedings are available in Scotland. It provides that a member of a company may raise proceedings in respect of an act or omission specified in subsection (3) in order to protect the interests of the company and obtain a remedy on its behalf. The proceedings must be in respect of an act or omission (actual or proposed) involving the breach by a director of a duty which he owes to the company. Section 265(6)(b) makes it clear that the section does not affect the court's power to make an order under section 996(2)(c). It was accepted by the parties that Ms Witter and Mr Gibb are members of the Company and that the proposed action is a derivative action for the purposes of sections 265 and 266 of the 2006 Act.

[6] Section 266 is concerned with the procedure to be followed. It provides that derivative proceedings may be raised by a member of a company only with the leave of the court. The application for leave must (a) specify the cause of action, and (b) summarise the facts on which the derivative proceedings are to be based. The sheriff sets out in paragraphs 8 to 11 inclusive of his note the procedure adopted, none of which we understand to be contentious. It accords in the main with the approach set out in *Wishart* v *Castlecroft Securities Limited* 2010 SC 16. The application to the sheriff was in the form of a

letter in compliance with the terms of rule 46.1(1) of the Ordinary Cause Rules 1993. Attached to the letter was a draft writ in which Ms Witter specified the remedy sought (decree for count, reckoning and payment) and summarised the facts upon which the derivative proceedings are to be based. In the draft writ Ms Witter set out two possible heads of claim at her instance on behalf of the Company against Mr Gibb – (i) an alienation of the training materials to Expelidor Limited for inadequate consideration (£1), failing an accounting she seeks payment of £250,000 for this material and (ii) unauthorised and unjustified intromissions with the Company's bank account by Mr Gibb through which it is alleged Mr Gibb acquired £109,500 and £154,000 of the Company's funds. The Company lodged detailed answers, denying the allegations. After hearing oral submissions, and having regard to the legislation and authorities, the sheriff refused the application. We set out the sheriff's approach in paragraphs 11-14 below.

[7] Section 266 (3) provides that "if it appears to the court that the application and the evidence produced by the applicant in support of it do not disclose a *prima facie* case for granting it, the court (a) must refuse the application, and (b) may make any consequential order it considers appropriate." This particular provision was scrutinised in the course of the appeal. The parties agreed that when the case called before him the sheriff had three options under section 266(5) - to continue consideration of the application (which he was not invited to do), to reach a final decision whether to refuse the application or to grant it.

[8] Section 268 is focused on issues relevant to the grant (or refusal) of leave. It provides:

> "(1) The court must refuse leave to raise derivative proceedings …. if satisfied—
>
> (a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to raise or continue the proceedings (as the case may be) …
>
> (2) In considering whether to grant leave to raise derivative proceedings ….., the court must take into account, in particular—

> (a) whether the member is acting in good faith in seeking to raise or continue the proceedings (as the case may be),
>
> (b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to raising or continuing them (as the case may be) ...
>
> (e) whether the company has decided not to raise proceedings in respect of the same cause of action or to persist in the proceedings (as the case may be),
>
> (f) whether the cause of action is one which the member could pursue in his own right rather than on behalf of the company….."

[9] Section 172 provides that 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", having regard to a number of factors including

> "(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,
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> (f) the need to act fairly as between members of the company."

[10] Counsel were agreed that there are thus two stages. First, following the lodging of the application, the sheriff considers only the application and the evidence produced by the applicant in support of it and must refuse leave if a person acting in accordance with section 172 would not seek to raise the proceedings (s.268(1)). If the application is not refused at the first stage, then the matter proceeds to a hearing in which the company is entitled to take part. That is what occurred here. As was observed in *Wishart* "The court will again have to consider whether it is satisfied that the application falls within the scope of section 266 and complies with the requirements of that section. The court will again have to consider the factors specified in section 268(2), and any other relevant circumstances. ….. If it is satisfied as to any of the matters mentioned in section 268(1), then it must refuse the application.

Otherwise, it must decide whether, in its judgment, the application ought to be granted." At this stage the sheriff has to make a judgement on all of the material in front of him or her.

The sheriff's approach

[11] In considering the application of section 268(1) at the second stage, the sheriff concluded that he had to be satisfied whether a director acting in accordance with the provisions of section 172 of the 2006 Act would not seek to raise proceedings, and if so to refuse the application. He was not attracted by the submission of the Company that as it was dormant and had no premises, staff, clients, assets, or funds, there was nothing to protect which would justify the instituting of proceedings. In our view he was correct to reject that submission.

[12] Rather, he concluded that the claims as set out in the draft writ in respect of the alleged alienation and the misappropriation of funds are lacking in substance and in candour, and that being so no board of directors, properly advised, and being mindful of the prospects of success and the likely costs of litigation, would choose to initiate these proceedings (paras 42, 46 and 47 of his note).

[13] The sheriff went on to consider, if he was wrong in relation to section 268(1), whether he ought to grant leave having regard in particular to the factors in section 268(2). In considering the s268 factors, he had particular regard to the behaviour of the appellant in 2009 and 2010 in forming a new company (CLPL) in direct competition to the Company, continuing to deal with clients of the Company through her new corporate vehicle, refusing to sign the Company accounts, destroying the business of the Company and acting repeatedly in breach of her duties to the Company under s172. The sheriff was concerned

about these activities and concluded that "Unlike the position in both *Wishart* and *Hughes* I am not satisfied that the applicant is acting in good faith."

[14] The sheriff then considered whether the appellant had open to her a remedy under section 994 of the 2006 Act. In that connection, he concluded that the dispute was "essentially between the members of the company as to how the business of the company ought to be wound up. It is the applicant who raises, in the proposed initial writ, the issue of the alleged failure of Mr Gibb to implement his part of an unspecified agreement in relation to her leaving the business. This is what the dispute is about".

Grounds of appeal

[15] We have extrapolated from the information in the note of appeal, three substantive grounds of appeal. The first ground of appeal is predicated on the sheriff having made a series of errors of law. Mr McLean confirmed that the errors are these:-

(i) the sheriff erred in holding that he was bound to refuse the application on the basis that a person acting in accordance with section 172 of the 2006 Act (a duty to promote the success of the company) would not seek to raise the proceedings taking into account the substance of the claims;

(ii) he took into account material that he ought not to have taken into account;

(iii) the sheriff was too ready to accept explanations from the Company which were in reality explanations of Mr Gibb;

(iv) he erred in his use of the expression "exercising his discretion" rather than "exercising his judgment" (this particular point was no longer insisted on);

The second ground of appeal is that the sheriff erred in finding that the appellant had an alternative remedy under section 994 of the 2006 Act. The third ground of appeal is that the

sheriff erred in concluding that the application had been presented in bad faith due in part to a lack of candour in the draft writ. During the hearing it was suggested that the sheriff erred in determining that the application was an attempt by the appellant to secure funding of litigation by her against Mr Gibb using the proposed derivative proceedings as a vehicle for that. We should make it clear that we have summarised the grounds of appeal and have not included, for the purposes of this note, the many minor subsidiary points.

The arguments before us

[16] We are grateful to counsel for their detailed written submissions, which they each supplemented during the hearing. These form part of the appeal process and accordingly we simply summarise their respective arguments. For Ms Witter, it was argued that the criticism made by the respondent that the appellant gave no value of the training material that the Company had transferred to Mr Gibb's company Expelidor Limited was not justified; the value of that material was not known to the appellant; the alternative claim for £250,000 was a notional figure based on the turnover figure in the company's profit and loss account for the year ending 30 April 2012 (document 5/1/2 in the appendix); and there was no value shown in the accounts of the Company because it was not a balance sheet item. In relation to the claim for £154,000, counsel for Ms Witter submitted that even if the sheriff was correct that there were counterbalancing payments in to the Company from Mr Gibb leaving only a balance of under £4,000, there was still the £109,500 unaccounted for. The sheriff had failed to take that into account.

[17] The explanations from the Company that Ms Witter had taken material and clients from the Company to a company she set up (CLPL), that all these sums taken out were payments for work done by him, in fact came not from the Company but from Mr Gibb and

had yet to be proved. The sheriff was wrong to perform the exercise he did of accepting the Company's explanation which could only have come from Mr Gibb. At the very least, directors of a company would pursue the loss of £109,500 acting in accordance with their duties under section 172.

[18] The section 994 petition was only one of the factors to be considered and not a determinative factor (*Alam v Ibrahim* [2016] CSIH 62 at para. [14]) and the only appropriate remedy in such a petition would be the authorisation under section 996(2)(c) of derivative proceedings. In other words, the remedy is the same as that being sought in the current proceedings.

[19] For the Company, counsel argued that none of section 172 factors applied here except possibly (f) – the need to act fairly. In relation to the value of the training material, he argued that one would expect some value to be put on it in order to support a *prima facie* case. He queried the explanation that no value was attributed to the training materials in the accounts because the value of the material was not a balance sheet item. The sheriff was entitled to have regard to the actions of Ms Witter in ceasing her involvement in the day to day management of the Company on 3 March 2010, in removing material from the Company and transferring it to CLPL, a company which she had set up in direct competition to the Company and in targeting clients of the Company.

[20] Counsel for the Company submitted that, faced with competing allegations about breaches of duties by directors when there are only two director who are also the only two members of a Company, the sheriff was bound to consider whether the explanation by the Company about the funds allegedly missing came only from Mr Gibb could be supported from another source. The sheriff was satisfied that such support could be found in the documents produced by the Company. These included the bank statement of the Company

(5/1/3 in the appendix), the first page of which showed £150,000 being taken out and the same amount being paid in. The sum of £109,500 was money owed to Mr Gibb for work carried out by him for the Company through yet another corporate vehicle - Irvine Meres Limited ("IML"). IML was incorporated by Mr Gibb in March 2012 IML had tendered invoices for the work to the Company. The Company accountants had not allowed these because IML had not been incorporated at the time of these invoices. The sheriff had regard to the accountant's notes (5/1/4 of the appendix) in deciding whether the appellant had a *prima facie* case and to conclude that it did not.

[21] It was also argued for the Company that the sheriff was entitled to have regard to the basis on which the Company alleged that Ms Witter did not have good faith. She had herself set up another company and had transferred to it material and clients from the Company. She owed £5,401 to the company in respect of a director's loan. The proper course was for Ms Witter to pursue a section 994 petition because that would allow all issues to be examined as a whole, including the allegations each made against the other of taking material out of the Company.

Decision

[22] Having regard to the terms of the application, the draft initial writ, the answers, the note of appeal, notes of argument for both parties and the authorities, we do not accept that the sheriff erred in law in the manner contended for by counsel for the appellant. In our view the sheriff was bound to refuse the application on the basis that a director acting in accordance with section 172 of the 2006 Act would not seek to raise the proceedings, taking into account the substance of the claims.

[23] Despite lengthy written and oral submissions, we still are unable to identify what material the sheriff took into account which he ought not to have. The principal complaint by Ms Witter is that the sheriff accepted the opposition proffered by the Company which she complains in reality is opposition from Mr Gibb. We accept that the fact that an application contains allegations of negligence or breach of duty by a director does not give that director a right to be heard on the application, but it was recognised in *Wishart* (para. [23]) that it is difficult to avoid in the case of a potential defender who remains a director. In our view, the sheriff was entitled to have regard to explanations from the Company, albeit explanations that may have come from the other director and member, Mr Gibb, just as he was entitled to consider the account posited by Ms Witter. There was some support from the documents before the sheriff for the explanation given by the Company whereas the appellant did not place before the sheriff material that appeared to support her contentions. She was silent on the allegation that she had taken material out of the Company. Ms Witter had allegedly walked away from the Company in 2010, set up in competition, took clients of the Company to her new venture and abrogated her responsibilities to the Company. Mr Gibb, on the other hand, continued to operate the business of the Company and was the controlling mind of it between March 2010 and March 2012. It is inevitable that the information in these proceedings may be derived from Mr Gibb.

[24] We can detect no error in the sheriff's approach in his consideration of the claims. It seems to us that the sheriff undertook the very exercise that he is required to do (*Wishart* (paras. [37 and 38]), Hughes *v Weiss* [2012] EWCH 2636 (Ch) and *Iesini v Westrip Holdings Ltd* [2010] BCC 420) by considering the material before him in regard to the two proposed heads of claim (paras 42-46 of his note). It is worth reminding parties that the sheriff was not obliged to investigate the merits of the proposed derivative proceedings in detail – and he

did not do so. The procedure here is summary. It is not intended to be lengthy, drawn out and costly. At the second stage, it is not a matter of establishing a *prima facie* case - something more than that is required (*Iesini* at para. 79); but, there is no particular threshold (*Hughes* at para 33). The court has to form a view on the strength of the claims in order to consider the requirements of section 268 – and that is what the sheriff did.

[25] In relation to the first head of claim for an accounting, failing which payment of £250,000, for the training material admittedly taken out of the Company by Mr Gibb, the sheriff had regard to the fact that no value was placed on the material by Ms Witter nor had she offered any methodology for its valuation. In our view, his approach was correct. The explanation given before us that the figure of £250,000 was derived from the turnover in the Company accounts is unconvincing. The accounts do not bear out that contention. It does not seem to us that directors of a company would pursue a claim without regard to whether it had value and what that value might be. In this case the value is speculative – that alone may not necessarily lead to the conclusion that a director acting in accordance with section 172 would not seek to continue the claim. Such a director would also have regard to the inherent risks in litigating, the prospects of success, the cost of the proceedings, the funding of the litigation, and the solvency of the other party (*Iesini,* para. 85). The sheriff was fully alert to the foregoing factors.

[26] Turning now to the second head of claim, in our view the sheriff was entitled to have regard to the explanation and supporting documentation in relation to the sums of £109,500 and £154,000. We do not agree that the sheriff either miscalculated the sum due or ignored essential elements of it. In paragraphs 26, 27, 43-46 of his note, the sheriff sets out the basis of that part of Ms Witter's claim and his view of it. The figure of £109,500, for work he says he did for the Company, has been treated by the accountants as a director's loan and the

Company is content to accept that position. The balance has no set repayment terms and is not subject to interest. The same conditions apply to monies due by Ms Witter to the Company. The sum of £154,000 has been offset by payments in the Company leaving a balance due of £3,700. With such a small sum at stake, the sheriff concluded, rightly in our view, that a director acting in accordance with section 172 would not seek to pursue such a claim.

[27] Having so concluded, there was no need for the sheriff to consider the provisions of section 268(2)(b). However, as he was presented with argument on the applicability or otherwise of section 268(2) factors as an *esto* position, the sheriff reflected upon whether it would have been open to him not to exercise his discretion to grant leave. The factor to which the sheriff's attention was drawn is that set out in section 268(2)(a) - whether the member is acting in good faith in seeking to raise the proceedings. In reaching his decision that the proposed action was not "an attempt in good faith to vindicate the rights of a member of the company" but was "an attempt to fund a continuation of a dispute between two members of the company at the expense of the company" the sheriff was, in our view, entitled to have regard to the fact that Ms Witter had an outstanding loan from the Company of £5,401 according to the draft accounts produced by Ms Witter with her application to the sheriff (para. 49 of the sheriff's judgment). He was also entitled to have regard to the allegation about her involvement with CLPL and transferring a project and clients to that company. We note that there has been no express denial of the allegations by Ms Witter either in her supporting material or in the oral submissions to us. The sheriff is, in our view, justified in concluding in paragraph 54 that there is a lack of good faith on the part of Ms Witter.

[28] Turning to the second ground of appeal, it seems to us in the specific circumstances of this application entirely appropriate for the sheriff to have had regard to the matter of an alternative remedy under section 994. Section 994(1) of the 2006 Act is in the following terms:-

> "(1) A member of a company may apply to the court by petition for an order under this Part on the ground–
>
> (a) that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself), or
>
> (b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."

[29] The governance of the Company has been called into question. As a consequence, the court "has in addition to consider the good faith of the applicant and his ability to pursue the cause of action in his own right" *(Wishart* at para. [20]). Ms Witter argues that, although her actions are not entirely altruistic, the loss was suffered by the Company and not by her. The Company cannot raise proceedings as it is controlled by Mr Gibb. The equitable way forward is to permit her to litigate for the benefit of the Company. In our view, this is disingenuous. The Company no longer trades. It has no assets and some debts which in reality are sums due to her and to Mr Gibb by way of unpaid dividends and by them to the Company through loans. Ms Witter walked away from the Company in 2010, leaving the business in the hands of Mr Gibb. She has failed to provide any information to the court about the terms of her alleged agreed departure from the Company. She abrogated responsibility for the then small number of staff, the contracts, and the clients other than

those whose business she secured for the benefit of her new venture. She refused to sign off the Company accounts for 2010-2012. She remains a director of the Company. She has taken no steps to resign that role or to sell her shares.

[30] We agree with the observation of the sheriff that Ms Witter does not have "clean hands". As Voss, LJ., indicated in *Singh v Singh*, [2014] EWCA Civ 103, at paragraph 23, with which we agree, section 994 gives the court a very wide power to rectify the position once it is discovered that the affairs of the company have been conducted in a manner prejudicial to the applicant. We do not think that the fact that this observation was made when he was sitting alone to determine whether permission to appeal should be granted makes the observation less worthy of consideration.

[31] It was suggested that an action of count, reckoning and payment is the only way for the Company to recover its assets or obtain an award for breach of duties under section 172 that led to their loss and thus affording relief to Ms Witter. It is not beyond dispute that the training material taken by Mr Gibb was a valuable asset. That is counter-balanced by the allegation that Ms Witter herself took material and clients from the Company. Both Ms Witter and Mr Gibb may owe money to the Company. What is required here is for the members to resolve how the business of the Company should be wound up rather than squabbling about a select few of their differences. As counsel for the Company observed, a section 994 petition allows all issues to be looked at as a whole, including the allegations each made against the other of taking material out of the Company. We are not persuaded that such remedy as is available under section 994 is restricted in the relief that can be provided or that the only available relief in the present circumstances would be an order to enable Ms Witter to bring an action on behalf of the company ie a derivative action.

[32] The issue of expenses of the derivative proceedings was briefly touched upon. Counsel were agreed that were we minded to grant leave, the expenses of the derivative proceedings ought to be deferred until the conclusion of those proceedings as the position here is really that of a quasi-partnership. We are grateful to them for reaching an agreement on that point.

[33] In conclusion, we are not persuaded that the sheriff has erred in his approach to refusing to grant leave to raise derivative proceedings. We are not persuaded that we should interfere with the sheriff's assessment of the material facts or his interpretation of the law. Accordingly we refuse the appeal.

[34] Counsel were agreed that expenses should follow success. Consequently, the appeal having failed, the objector and respondent is entitled to the expenses occasioned by it. We have also certified the appeal as suitable for the employment of junior counsel.