8 December 2010

PRESS SUMMARY

Progress Property Company Limited (Appellant) v Moorgarth Group Limited (Respondent) [2010] UKSC 55

JUSTICES: Lord Phillips (President), Lord Walker, Lord Mance, Lord Collins, Lord Clarke

BACKGROUND TO THE APPEAL

The issue in this appeal is whether there may have been an unlawful distribution of capital to a shareholder when the Appellant ("PPC") sold the whole issued share capital of a wholly-owned subsidiary YMS Properties (No 1) Ltd ("YMS1") to the Respondent ("Moorgarth"). PPC and Moorgarth were both subsidiaries of Tradegro (UK) Ltd ("Tradegro"). It was accepted that Mr Moore, a director of both PPC and Moorgarth, had genuinely believed that the sale of the shares was at market value. However PPC later claimed that the sale had been at an undervalue. The appeal raises a question as to the approach to be taken to establishing whether there has been an unlawful distribution of capital by a company.

The factual background to the sale lies in the corporate structure being used to carry on the business of another company, called simply YMS Limited ("YMS"), which at the relevant time had also become a subsidiary of Tradegro. Mr Price was appointed as managing director of PPC and became holder of 24.9% of its shares. Tradegro retained 75.1% of PPC's shares. The freehold interests in the properties from which YMS traded were held by another company, YMS Properties (No 2) Ltd ("YMS2"). YMS2 was a wholly owned subsidiary of YMS1, which was itself a wholly owned subsidiary of PPC. YMS occupied the properties on an informal basis. YMS2's property portfolio was used as security to borrow money. The lender insisted that formal leases be entered into between YMS2 (as holder of the freeholds) and YMS (as occupiers of the properties). These were to include full repairing and insuring obligations on the tenants. The properties were in significant disrepair at the time. The cost of repairs was estimated at £4.6m and YMS was not able to bear that liability. It therefore sought an assurance that it would be given an indemnity against the costs which it might have to pay to satisfy the repairing liability to YMS2. Although it received that assurance, no indemnity or counter-indemnity was ever entered into. Later, following a falling out of those involved in managing the business, it was agreed that Mr Price should acquire Tradegro's 75.1% holding of PPC. A preliminary step was to be the sale by PPC of the whole share capital of YMS1 to Moorgarth, another subsidiary of Tradegro. In effect, the YMS properties were being extracted from PPC prior to its sale to Mr Price.

On 20 October 2003, PPC agreed to sell the whole issued share capital of YMS1 to Moorgarth for £63,225.72. The sale price was calculated on the basis of the open market value of the YMS1 properties (said to be £11.83m), less liabilities for creditors approaching £8m and the sum of £4m in respect of repairing obligations. The deduction of £4m was made in the belief that PPC had given an indemnity or a counter-indemnity in respect of YMS's repairing liabilities under the leases, under which that liability would ultimately fall on PPC. As part of the sale by PPC to Moorgarth, PPC's liability under that indemnity or counter-indemnity was to be released. In fact, there was no indemnity or counter-indemnity.

PPC (now under the control of its new owner) claimed that the sale was at an undervalue, by as much as £4m, and was in breach of the common law rule against unlawful distributions of capital. It was not, however, disputed that Mr Moore, a director of both PCC and Moorgarth at the time the sale was negotiated, genuinely believed that the sale of the shares was at market value. The claim was dismissed in the High Court and by the Court of Appeal.

JUDGMENT

The Supreme Court unanimously dismisses the appeal. Lord Walker gives the main judgment. Lord Mance agrees with it, but issues a separate judgment. Lords Phillips, Collins and Clarke agree with both.

REASONS FOR THE JUDGMENT

Lord Walker holds that that whether a transaction infringes the common law rule against unlawful distributions is a matter of substance and not form. The label attached by the parties is not decisive: **[16]**. The essential issue was how the sale is to be characterised: **[24]**. PPC argued that the court should adopt an "objective approach", so that there is an unlawful distribution whenever a company enters into a transaction with a shareholder which results in a transfer of value not covered by distributable profits, regardless of the purpose of the transaction. Such a relentlessly objective rule would be oppressive and unworkable. It would tend to cast doubt on any transaction between a company and a shareholder, even if negotiated at arm's length and in perfect good faith, whenever the company proved, with hindsight, to have got significantly the worse of the transaction: **[24]**. The court's task is to inquire into the true purpose and substance of the transaction. That calls for an investigation of all the relevant facts, which sometimes include the state of mind of the human beings involved: **[27]**. Sometimes their states of mind are totally irrelevant. They will be irrelevant, for example, where a distribution described as a dividend is actually paid out of capital. Where there is a challenge to the level of director's remuneration, the test is objective but probably subject to a "margin of appreciation": **[28]**. The participants' subjective intentions are, however, sometimes relevant. Something said to be an arm's length commercial transaction is the paradigm example: **[29]**. If the transaction was a genuine arm's length transaction then it will stand, even if it may, with hindsight, appear to have been a bad bargain for the company. If, however, it was an improper attempt to extract value from the company by the pretence of an arm's length sale, it will be held unlawful. Deciding which category the transaction falls into will depend on a realistic assessment of all the relevant facts, not simply a retrospective valuation exercise in isolation from all other inquiries: **[29]**. Here there were findings by the Deputy Judge and the Court of Appeal that this was a genuine commercial sale. The appeal was therefore dismissed: **[33]**.

Lord Mance agreed with Lord Walker's reasoning and conclusions. The courts will not second-guess companies with regard to the appropriateness or wisdom of the terms of any transaction. There may, however, come a point at which, looking at all the relevant factors, an agreement cannot be regarded as involving in substance anything other than a return or distribution of capital, whatever label the parties attach to it: **[42]**. That was not the position here: **[45]**. It could not be said that YMS1 was sold at an undervalue. The reason why only £63,225.72 was paid to PPC was not related to the question of the net value of the YMS properties. It was because PPC itself was seen as having independent counter-indemnity obligations to Tradegro which would reduce any sum payable by Moorgarth to PPC (such as the purchase price for YMS1 shares): **[45]**. Directors can make mistakes about the extent of liabilities attaching to their companies. Even if ill-advised or unwise, it does not follow that settlement of such a liability must be re-categorised as a distribution of capital, even if it is in relation to a shareholder: **[46]**.

NOTE
This summary is provided to assist in understanding the Court's decision. It does not form part of the reasons for that decision. The full opinion of the Court is the only authoritative document. Judgments are public documents and are available at:
www.supremecourt.gov.uk/decided-cases/index.html