UPDATE

MARCH 2015

mourant

Kilbey v Grafters: A quasi-partnership gone wrong: use of without prejudice statements at trial; unfair prejudice; and indemnity and split costs orders

Update prepared by Bruce Lincoln (Partner, Jersey) and Mathew Cook (Counsel, Jersey)

In a series of judgments, the Royal Court of Jersey has considered a number of points arising from the breakdown of relationships in a quasi-partnership. The judgments concern: (a) whether a heated exchange in a mediation could be admitted as evidence in subsequent proceedings; (b) whether a claim for unfair prejudice was made out; and (c) how to deal with the costs, which dwarfed the value of the claim, of these proceedings.

In a series of judgments in the proceedings of *Kilbey v Grafters Limited* and others the Royal Court has given judgment on:

- when statements used in a mediation can be referred to in subsequent proceedings;
- the relevant test in an unfair prejudice claim; and
- how to deal with the substantial costs of such proceedings.

We consider each aspect below.

What happens in mediation, stays in mediation

In the recent case of *Kilbey v Grafters Limited* [2014] JRC 227, the Royal Court considered whether or not to allow statements made in an unsuccessful mediation to be referred to in the subsequent trial of the proceedings. The Court held that the statements were not admissible as there was no basis for overriding the without prejudice privilege applying to the mediation.

The facts of the case were as follows:

- The first defendant (Grafters Limited (Grafters)) was a company in the business of placing casual labour to a variety of businesses, mostly in the construction and fulfilment industries. The second and third defendants were directors and shareholders. They had set up Grafters with one other individual, but he left the business in October 2006 and sold his shares to the Plaintiff, Mr Kilbey. The Plaintiff, Mr Kilbey, therefore joined the business as an equal shareholder and director.
- The relationship between the three individuals broke down and, in March 2007, Mr Kilbey was removed as a director (but remained a shareholder). Shortly thereafter, Mr Kilbey incorporated a new business that was similar in nature to Grafters.
- Mr Kilbey proceeded to issue proceedings against Grafters and his former colleagues for unfair prejudice. The Defendants subsequently made allegations that Mr Kilbey had taken data from Grafters and was using that data in his new business (data such as customer and labourer databases, contact information etc). There was an investigation by the Data Protection Commissioner, and Grafters issued a counterclaim in respect of those allegations. In the proceedings, Mr Kilbey admitted to copying certain parts of the data (although not all) but denied doing so to further his own business interests.
- A mediation took place in September 2011. There was a mediation agreement in the usual form, including a provision that information produced or arising from the mediation (as well as what was said during it) would be confidential and privileged. The Defendants alleged that, during what was a heated exchange during opening statements, Mr Kilbey said 'Of course I took the data and used it … I have done everything I can do to destroy the business and to destroy you.' (pointing to one of the individual

defendants). Despite his lawyer advising him to stop speaking, he was then alleged to say 'There is nothing you can do about it.'

For reasons that will be obvious, the Defendants wished to adduce evidence of this discussion at the trial.

It was common ground between the parties that, quite apart from the express terms of the mediation agreement, a mediation is a without prejudice meeting and so statements made during it will be inadmissible at trial subject only to certain limited exceptions. One such exception is where the exclusion of evidence would act as a 'cloak for perjury, blackmail or other unambiguous impropriety'; the so called 'unambiguous impropriety' exception.

The Defendants argued that the inconsistency between the statements made at the mediation and what was said in affidavits and pleadings in the proceedings fell within the exception.

The Court looked to English authorities, as there was no relevant Jersey authority on the point, and held that Jersey law is to like effect as English law. The English authorities established a high burden on a party wishing to adduce evidence of what transpired in a mediation. The Courts have repeatedly impressed that there are strong public policy grounds for protecting without prejudice privilege in order to assist open and frank settlement discussions.

In the case of *Unilever PLC v Proctor and Gamble Company* [2000] 1 WLR 2436, the English Court had stated:

> 'Parties cannot speak freely at a without prejudice meeting if they must constantly monitor every sentence, with lawyers or patent agents sitting at their shoulders as minders.'

Further, in *Forster v Friedland* [1992] Court of Appeal (Civil Division) Transcript No. 1052 of 1992:

> 'I think it is quite wrong for the tape recorded words of a layman, who has used colourful or even exaggerated language, to be picked over in order to support an argument that he intends to raise defences which he does not really believe to be true.'

The preservation of this protection appears to be treated as paramount. As stated in Hollander, Documentary Evidence (11th edition) paragraph 2026:

> 'There will always be applications to admit without prejudice evidence on the grounds of 'unambiguous impropriety'. Where a party says one thing at a without prejudice meeting, it sticks in the throat to permit him to say something quite different in a witness statement or in evidence without trying to adduce evidence of what he told everyone at the without prejudice meeting or in without prejudice correspondence. But, as the court recognised in Fincken there are serious risks in undermining the willingness of parties if the 'unambiguous impropriety' exception is implied in other than the most egregious cases, and most of the time, public policy will trump the outrage felt by those who have been told a rather different story on a without prejudice basis.'

The Defendants attempted to argue that Mr Kilbey's comments had not been made for the purposes of seeking to settle the matter, but rather to taunt the Defendants, which was likely to be damaging to settlement discussions, and so he should not be able to take advantage of the rule. The Court rejected that argument.

The Court ultimately found that the statements made in the mediation should remain inadmissible in the proceedings. The court considered the public interest in encouraging settlement to be 'extremely strong' and that settlement meetings should be conducted on the basis that parties can be confident they can 'lay all their cards on the table without fear of something they say coming back to bite them later'. There was concern that the widening of any exception to the rule over without prejudice discussions would lead to; a lack of clarity for parties engaged in mediation; a possible reluctance to fully engage in mediation; and the potential for collateral litigation over what was or was not actually said.

This case clearly demonstrates the importance placed by the Court on open and frank settlement discussions. Clearly, however, the best approach is to present your case in both the proceedings and mediation in a truthful, consistent, and calm manner. Nonetheless, the judgment should give comfort to parties involved in litigation in Jersey that they can engage freely in without prejudice negotiations, safe in the knowledge that, if those negotiations are unsuccessful, their content will, in all but very exceptional cases of clear impropriety, be protected from disclosure in the Court proceedings.

The unfair prejudice claim

In its judgment on the substantive proceedings, the Court considered Mr Kilbey's claim that the individual defendants had conducted the affairs of Grafters in a manner that was unfairly prejudicial to his interests as a member of Grafters, contrary to Article 141 of the Companies (Jersey) Law 1991.

The issue to be determined by the Court ultimately fell to consideration of four questions:

1 Was this a quasi-partnership?

The Court had no doubt in finding that the relationship between the individuals was a quasi-partnership. Mr Kilbey had put all of his savings into the business and the relationship established between the directors was a personal relationship involving mutual confidence between them.

Grafters was a company and so the relationship between shareholders was ordinarily governed by the terms of the articles of association. It would not ordinarily be unfair for the affairs of a company to be conducted in accordance with the articles of association. However, equitable considerations may be applied where certain elements of a personal relationship are present. The case of *Ebrahim v Westbourne Galleries Ltd* [1973] AC 360 established:

> 'The superimposition of equitable considerations requires something more, which typically may include one or probably more of the following elements (i) an association formed or continued on the basis of a personal relationship, involving mutual confidence – this element will often be found where a pre-existing partnership has been converted into a limited company; (ii) an agreement, or understanding, that all, or some (for there may be 'sleeping' members), of the shareholders shall participate in the conduct of the business; (iii) restriction upon the transfer of the members' interests in the company – so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere …'

The Court found that all three elements were satisfied in this case.

2 Did Mr Kilbey's conduct justify his removal as a director without a reasonable offer for his shareholding?

The Court heard evidence from all three directors as to the circumstances leading to Mr Kilbey's removal from office. The version of events presented differed substantially:

- Mr Kilbey alleged that Grafters was a loss-making business that he 'turned around'. He further contended that one of the other directors had tried to conspire with him to remove the third director in order to increase his profit share, but when that failed the other two directors instead turned on him to remove him;
- Mr Baker and Mr Jones presented a different story. They alleged that Mr Kilbey had failed to contribute to Grafters and that his general attitude and relationship with staff and clients was having a detrimental impact on the business.

The Court found there to be 'serious issues' as to the credibility of Mr Kilbey and found his evidence to be 'unreliable at best'. The Court preferred the version of events put forward by Mr Baker and Mr Jones. In determining whether the treatment of Mr Kilbey was unfair or not, the Court noted, in particular that: (a) criticism of Mr Kilbey's performance as a director had been made on two occasions; (b) Mr Kilbey was given 15 days' notice of the EGM where he was to be removed, and the notice set out the reasons for his removal. Mr Kilbey did not seek to make any written representations about either the merits or the process; and (c) Mr Kilbey was given the opportunity to attend the EGM and did so.

The Court found that Mr Kilbey's conduct was serious and that he was removed for a reason. However, the conduct was not so serious as to remove him without making a reasonable offer for his shareholding.

3 Did Mr Baker and Mr Jones make a reasonable offer for Mr Kilbey's shareholding?

Mr Kilbey had been removed from office in March 2007. The business proceeded to grow steadily until 2012, when 'Low Value Consignment Relief' (LVCR) was abolished, effectively bringing the fulfilment industry in Jersey to a close and causing the profits of Grafters to fall dramatically.

The Court received expert evidence from each side, and ultimately had to determine whether an offer made in March 2007 to Mr Kilbey was reasonable or not. The Court considered in particular:

- Grafters, at that point, had barely been trading for a year, and it is inherently difficult to place any value on such a nascent business.
- The financial information available to Mr Baker and Mr Jones was that produced by Mr Kilbey as finance director. It showed a net profit for March 2006 to February 2007 of £12,402.92.
- Mr Kilbey had paid £25,000 for his shares just four months earlier. Mr Kilbey's expert valued the shares at £250,000, a tenfold increase which the Court rejected.
- The business was reliant on two clients and on LVCR and was a seasonal business.

The Court considered that Mr Kilbey had received a reasonable offer, in that the offer involved the recoupment of the money recently paid for his shares, gave him a share in the profits going forward and gave him the benefit of a new venture that had been established within the business by Mr Kilbey. The Court also found the offer was made in good faith.

Mr Kilbey rejected the offer made and suggested an alternative valuation should be carried out by a valuer suggested by him. He ultimately also rejected the valuation put forward by that expert, and made allegations that the valuer had been 'got at' by Mr Baker and Mr Jones, an allegation the Court rejected.

If the Court had concluded that the offer put forward to Mr Kilbey was not a reasonable offer, unfair prejudice would have been established. In those circumstances, the Court would need to make an order for the acquisition of Mr Kilbey's shares on the basis of a valuation by the Court. The point was not relevant as the Court had determined a reasonable offer had been made, although the Court did nonetheless go on to consider the point.

4 What value should the Court place on Mr Kilbey's shareholding?

For the purposes of a Court determination, the Court was not simply to determine what the value of the business was in March 2007 when Mr Kilbey was removed, but had to take into account all of the circumstances of the case and in particular the conduct of the parties since March 2007, including the various offers made and rejected.

In addition, allegations were made by Mr Kilbey that Mr Jones and Mr Baker had awarded themselves excessive remuneration, thereby reducing the amounts available to Mr Kilbey as a shareholder. The Court rejected that argument.

The date of valuation for an order for purchase by the Court would be the date of that order, unless it could be established that an earlier date should be applied because the remaining directors had acted in an unfairly prejudicial manner since Mr Kilbey's exit from the business. Grafters had suffered a substantial decline in its profits since the abolition of LVCR, and the board had reduced to one director. It had also suffered due to competition from Mr Kilbey's new business.

The Court ultimately determined that a fair value for Mr Kilbey's shareholding was the return of the price he initially paid.

The Court also went on to consider the counterclaim from the respondents concerning the removal by Mr Kilbey of certain of Grafters' data. The Court found that Mr Kilbey had removed that data secretly and in breach of his fiduciary duties. It was distinct from information in his head (which he would be permitted to use) and he had relied on the data taken to contact third parties. The use of the data was relatively limited, and the Court awarded nominal damages of £100 against Mr Kilbey.

The costs outweigh the claim

In a subsequent judgment, the Court considered the issue of costs. As set out above, the Court had determined that if Mr Kilbey had been successful, the value of his shareholding for the purposes of an order for the purchase of his shares would be the amount he originally paid in 2007, which was £25,000. Mr Kilbey's costs were approximately £360,000 (excluding disbursements) and the respondents' costs were £301,000 including disbursements. The costs were, therefore, grossly disproportionate to the value of the subject matter of the litigation.

The Court referenced the well-established principles to apply when considering an award for costs, and the overriding objective to do justice between the parties. This was summarised in *Watkins and Connell v Egglishaw and Four Others* [2002] JLR 1, where it was stated:

> 'It is, accordingly, open to the court to have regard to any and all considerations that may have any bearing on the overriding objective of doing justice. Its task is to take an overview of the case as a whole (Bank of Credit & Commerce Intl. v. Ali (No. 4)(3) per Lightman J.). The new Civil Procedure Rules governing civil litigation in the English courts provide that the court 'must have regard to all the circumstances' and then go in to spell out certain matters that such circumstances include, the 'conduct of all the parties' being one and 'whether a party has succeeded on part of his case, even if he has not been successful' on another (Civil Procedure Rules, para, 44.3(4)).'

The respondents had been successful in defeating Mr Kilbey's unfair prejudice claim and also in the counterclaim. However, the respondents had not been successful on all issues. For instance, the respondents had refused to acknowledge the existence of a quasi-partnership, an issue on which the Court had said it had 'no doubt' and disposed of in one paragraph of the judgment. The Court had also found that Mr Kilbey's conduct was not so serious as to justify his removal from office without a reasonable offer for his shares being made. As such, Mr Kilbey had succeeded on certain issues and it was argued that the costs judgment should reflect that.

The Court, however, did not consider this to be a case where the respondents, as the successful parties, should be deprived of their costs because they raised issues on which they failed, even though they succeeded overall, or that they should be deprived of costs because they had raised issues improperly or unreasonably. The issues on which the respondents had failed were factual issues raised by Mr Kilbey that they denied and the Court was satisfied that it was not unreasonable for the respondents to respond to the relevant allegations.

An application for indemnity costs was made and, whilst the Court stated it came close to awarding indemnity costs, it was not ultimately persuaded that Mr Kilbey's conduct was such that indemnity costs were justified. The Court accepted that the case put forward on behalf of Mr Kilbey on the point at the heart of the litigation, namely whether the offer put forward for Mr Kilbey's shareholding was unreasonable or not, was not 'hopelessly bad'.

The Court therefore awarded standard costs to the respondents, and also made an order for an interim payment on account of those costs.

The respondents had not succeeded in all parts of the litigation, in particular failing to get an order that statements made in the mediation could be adduced as evidence in the proceedings. The Court considered that that application could be dealt with in isolation, and awarded Mr Kilbey his costs in respect of that aspect.

Contacts

Bruce Lincoln
Partner, Jersey
+44 1534 676 461
bruce.lincoln@mourant.com

Mathew Cook
Counsel, Jersey
+44 1534 676 371
mathew.cook@mourant.com