Case report
Shepherds Investments Ltd v Walters

Edward Brown: Essex Court Chambers

In the recent decision in *Shepherds Investments Ltd v Walters,* Etherton J, sitting in the Chancery division, set out a broad new approach to the permissibility of employees taking "preparatory steps" to set up in competition with their employer. Edward Brown reports

The facts

The defendants in the case were all former directors or senior employees of Shepherds, an investment fund that traded in individual life insurance policies. It made its profit by judging which policies would accrue earliest (by reason of the beneficiary deceasing) and assessing their corresponding value.

As is normal at such a company, Shepherds relied primarily upon the skills and experience of its traders. As is also the custom, Shepherds sought to secure its employees' loyalty with high salaries and appropriately worded restrictions in their contracts of employment.

Two of the three defendants owed fiduciary duties as directors, irrespective of the terms of their contracts of employment. In respect of the single defendant who was not formally a director, the judge noted that in appropriate circumstances, a senior employee could owe fiduciary duties (*Nottingham University v Fishel)*. However, the judge had little difficulty in finding that this defendant owed equivalent fiduciary duties, having held himself out as a director in fact (*Re Hydrodam (Corby) Ltd)*.

Against this background, the defendants, while still in employment and without authorisation from Shepherds, began discussing the creation of a new investment fund to compete in the traded life policy market. The new team distinguished itself from Shepherds by intending to focus upon a slightly different section of the market (the "whole", rather than the "fractionalised" life policy market). These discussions resulted in a draft business plan, emphasising the new team's experience and including significant improvements that, in their view, could be made to the "Shepherds model". The defendants also developed possible links with banks and auditors for the future transactions and prepared financial predictions for the first few years of trading. In short, much of the groundwork for the future business was in place by the time some (but not all) of the defendants came to resign formally from Shepherds.

Following the resignations of two of the three defendants, the new fund was formally incorporated, and various banking and auditing formalities concluded. Promotional literature was ordered and shortly thereafter the first transactions took place. Soon after that, Shepherds itself decided to move into the whole life policy market and began trading. Upon discovering the extent of the new team's activities, Shepherds brought claims against its former employees for breach of fiduciary duty, and in contract for breach of express contractual terms and the implied term of fidelity.

"Preparatory steps" to compete

In his decision, Etherton J came down firmly on the side of the company, finding the defendants to have breached both their fiduciary and contractual duties. He held that the steps taken crossed the line between legitimate entrepreneurial activities and illegitimate competition. The significance of the decision lies in the judge's assessment as to where that line should properly be drawn.

The previous authorities

Previously, the courts had permitted preliminary steps that fell short of actual competitive activities. Accordingly, in a line of cases beginning with *Balston v Headline Filters*, judicial policy protected fiduciaries who began setting up a competitor company while still in employment, providing it only began trading post-employment (and post-expiration of any reasonable and necessary restrictive covenants).

Identification of premises and the negotiation of a lease; the purchase of an off-the-shelf company; and tendering for contracts all constituted permissible steps. Such a dividing line was upheld in the subsequent decisions of *Framlington Group v Anderson* and *Coleman v Oakes*, in which *Balston* was cited and approved.

However, the *Balston* approach sat uneasily with subsequent decisions regarding the obligation of a fiduciary to report his own competitive activities to his employer. In *British Midland Tool Ltd v Midland International Tooling Ltd*, Hart J considered it a "simple proposition" that a director should report any "nascent commercial threat" to the company, particularly where he was personally involved.

The judge considered this duty to arise both from his position as a fiduciary, and by reason of the implied term of fidelity (see *Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] 1 All ER 350).

In *Item Software (UK) Ltd v Fassihi*, the Court of Appeal held that it was incumbent upon a fiduciary to disclose his own participation in the setting up of a rival company as such activities did not constitute legitimate entrepreneurial activities.

The new approach

Etherton J's decision casts significant doubt on the correctness of the *Balston* line of authorities. He held that where a conflict arose between the duty of the director to his company and the policy concern of restraint of trade, there could be no suggestion that the policy "trumped" the director's duty. Insofar as there was any conflict between *Balston* and *British Midland Tools,* the judge held that the *British Midland Tools* approach was to be preferred (paragraph 105).

The judge further held that whether any particular act was permissible depended on the facts of the case. Although discussing an idea with friends and family would be fine, poaching of customers clearly crossed the line. Acts between these two ends of the spectrum were a matter for determination by the judge in the case. The crux was whether an irrevocable intention had been formed by the performance of a particular act.

Significantly, Etherton J also held that the same acts constituted a breach of the implied term of fidelity (paragraph 129). This finding therefore holds mere employees and fiduciaries to the same standard in respect of any preparatory acts. In most instances, it will be of little relief to a mere employee that the employer's remedies would be limited to damages and not an account of profits in such circumstances.

Permissible acts post-*Shepherds*

Etherton J's analysis and findings of fact suggest that the scope of permissible acts is remarkably limited. Although he expressly considered it permissible to formulate an intention to leave employment at some point in the future and to discuss potential projects with family and friends, the judge left virtually any further act liable to cross the line. In particular, the following acts can no longer be considered safe in light of the decision:

- identifying suitable premises for the new business, and negotiating a lease and signing it (*Balston v Headline Filters*);
- purchasing an off-the-shelf company (*Balston v Headline Filters*);
- negotiating and agreeing terms of employment with a competing business (*Framlington Group v Anderson*)
- encouraging (or even failing to act to thwart) the recruitment of employees by a competitor (*British Midland Tool Ltd v Midland International Tooling Ltd)*
- preparing a company for incorporation (*Shepherds Investments Ltd v Walters)*
- contacting investment banks for support several months prior to the commencement of trading (*Shepherds Investments Ltd v Walters)*
- contacting lawyers with details of the proposals (*Shepherds Investments Ltd v Walters)*.

Inevitably, the weight given to any one act will be a question of fact and degree, depending on the circumstances of the case. The focus of the court's attention will be on the extent to which any one act constitutes evidence of a settled intention. Clearly, the existence of several acts will strengthen the case against an alleged wrongdoer. However, no guidance was given in *Shepherds* as to whether any acts might have the status of aggravating factors and this may fall to be decided by future courts.

The specific problem facing legal advisers

The comments made in *Shepherds* in relation to contact with lawyers are significant. In particular, lawyers should be aware that their own legal advice may, unwittingly, cause a client to cross the line. Further, it may not be safe for lawyers to assume that any such contact would be covered by legal professional privilege.

Although the judge did not expand beyond the general comment that consulting lawyers may cross the line, a distinction can be drawn between two broad situations:

- first, if a client approaches his or her solicitors seeking advice about the legal implications of a proposed course of conduct, such a step cannot have been intended to constitute a breach of duty. It is clearly in the public interest that individuals are able to establish the extent of their legal obligations and the implications of any wrongdoing; nothing in *Shepherds* should be taken as suggesting otherwise. As such, any advice given by solicitors in this respect would be covered by LPP
- secondly, if a client approaches his or her solicitors seeking assistance in relation to the implementation of a proposal, he or she may, at that stage, have crossed the line. Legal teams are placed in an invidious position when contacted out of the blue by a client to discuss proposals that are sufficiently advanced. By agreeing to a meeting, advisers may unwittingly cause clients to cross the line. Any active participation by lawyers in furthering the clients' objectives may not necessarily be privileged, on the ground that privilege cannot be used as a cloak for iniquity. Again, this will depend on the circumstances of the case. In any event, even if a client does have a dishonest (or even fraudulent) intention, it will not always follow that the proposed conduct would be regarded as iniquitous by the court. It is likely therefore that privilege will only be lost in rare cases, if at all.

Conclusion

The decision has significant implications for both directors and employees, and those advising them. The message is

clear: if a client has formulated an irrevocable intention to compete and wishes to avoid liability, he or she must usually be advised to resign. Obviously, a remedy in damages may survive if the employee's activities are in breach of any post-termination restrictive covenants. Those acting as legal advisers must consider their own role as advisers in any such competitive activity, insofar as they assist a client's wrongful acts and cause him or her to incur further liability.

The decision also does little for the common law's traditional objective of keeping potential restraints of trade within reasonable bounds. As Arden LJ commented in *Item Software v Fassihi* (paragraph 63), an overly intrusive approach to the law would discourage legitimate entrepreneurial activity and would not be a beneficial outcome. The line drawn in *Shepherds* offers scant protection for employees contemplating the establishment of a competitor company, who fail to resign at an early date. Accordingly, entrepreneurial activities by employees in the same sector as their existing employment (which may well be the only sector they know) are now strongly discouraged.

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Cases referred to:

Shepherds Investments Limited v Walters [2006] EWHC 836 (Ch)

Nottingham University v Fishel [2000] IRLR 471

Item Software (UK) Ltd v Fassihi [2004] EWCA Civ. 1244; [2005] ICR 450

Re Hydrodam (Corby) Ltd [1994] 2 BCLC 180

Balston v Headline Filters [1990] FSR 385

British Midland Tool Ltd v Midland International Tooling Ltd [2003] EWHC 466; [2003] 2 BCLC 523

Framlington Group v Anderson (1995) 1 BCLC 475.

Coleman v Oakes [2001] 2 BCLC 749.

Hivac Ltd v Park Royal Scientific Instruments Ltd [1946] 1 All ER 350