Radcliffe Chambers

MINORITY SHAREHOLDERS & UNFAIR PREJUDICE

BY DOV OHRENSTEIN OF RADCLIFFE CHAMBERS

INTRODUCTION

1. Parties may have expectations and common understandings as to how a business will be run. When those expectations are not met or there is a departure from the common understanding, there may be a conflict between the rights of the majority shareholders under the articles to control the company and the expectations of the minority. Such conflicts regularly come before the courts.

LEGISLATIVE HISTORY

2. It has always been the case that if a majority shareholder acts oppressively towards the minority that the latter may petition the court to wind up the company on the ground that it is *just and equitable* to do so. (see now s.122(1)(g) of the Insolvency Act 1986). However, it is often not in the interests of the minority shareholder for the company to be wound up as:

   - this drastic remedy would result in the sale of company assets at break up value without regard to good will;

   - long term company debts may become due immediately;

   - the process of winding up the company is slow;

   - the liquidator's expenses may be high.

3. Accordingly, legislation (s.210 of Companies Act 1948) introduced an alternative remedy. This was based on the concept of *"oppression"*. However, the courts were restrictive in their application of this remedy and it was often more difficult to obtain than a *just and equitable* winding up.

4. The Companies Act 1980 (s.75) attempted to overcome the limitations of s.210 by introducing the concept of *unfair prejudice* in place of *oppression.* This concept was then carried through into s.459 of the Companies Act 1985. Part 30 (ss 994-999) of the Companies Act 2006 replicates the *unfair prejudice* provisions of the 1985 Act.

5. The old case law on what amounts to *oppression* is still of relevance because oppressive conduct would inevitably amount to unfair prejudice although not all conduct which is unfairly prejudicial would have met the oppression test.

SECTION 994 OF COMPANIES ACT 2006

6. Section 994 of the 2006 Act (like s.459 of the 1985 Act) provides that a member of a company may petition the court on the grounds that

   - the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself)

   - an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

WHO MAY PETITION?

7. By s.994 any *member* may petition. This has an extended meaning and includes:

   - Someone to whom shares have been transferred
   This requires that an instrument of transfer has been executed even if not registered.[1]

   - Someone to whom shares have been transmitted by operation of the law
   i.e. personal representatives, trustees in bankruptcy, etc.[2]

8. A person who is a mere nominee shareholder is a member and may petition because his interests include the economic interests of the beneficial owners.[3]

9. A person who is a mere beneficial owner of shares may not petition.[4]

10. A former member has no standing to petition.[5] However, other members may be injuncted to prevent the compulsory acquisition of a petitioner's shares.

11. Although the petitioner must be a member of the company when the petition is presented, he may rely in support of the petition on events which occurred before he became a

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[1] **Re Quickdrome Ltd** [1988] BCLC 370

[2] CA 2006 s.112

[3] **Re Brightview Ltd** [2004] BCC 542

[4] **Re McArthy Surfacing** [2006] EWHC 832 (Ch)

[5] **Re a Company No 00330 of 1991** [1991] BCLC 597

member.[6]

12. There is no requirement to be a minority shareholder.

- Section 994 can apply where there are shareholders with equal holdings.

- In those rare cases where there is minority shareholder control then the majority shareholder could petition.[7]

- However, the court will not grant a majority shareholder a remedy under s.994 where the prejudice can be avoided by the exercise of his rights as majority shareholder.[8]

INTERESTS OF PETITIONERS AS MEMBERS

13. For a petition to succeed the affairs of the company must be conducted in a way which is unfairly prejudicial to the interests of some/ all members including the petitioner's own interests.

14. The conduct need not impact on the interests of petitioners in their capacity as members so long as it is sufficiently connected with membership, eg the exclusion of a member from the board of directors.[9] It has been held that a petitioner did have a legitimate interest as member in becoming or remaining as non-executive chairman of a small company in order to protect the capital contributions he has made to the enterprise, including capital contributions made by way of loans.[10]

15. Section 994 cannot be used to protect any interest of a petitioner who happens to be a member, for example:

- Where there is what amounts to an employment dispute but the employee also happens to own a few shares.

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[6] **Lloyd v Casey** [2002] 1 BCLC 454

[7] **Re Ravenhart Service (Holdings) Ltd** [2004] 2 BCLC 376

[8] **Re Baltic Real Estate** [1993] BCLC 503

[9] **Re a Company** [1986] BCLC 376

[10] **Tay Bok Choon v Tahansan Sdn Bhd** [1987] 1 WLR 413 PC. See also **Gamlestaden Fastigheter AB v Baltic Partners Ltd** [2007] UKPC 26 where there was a loan by a member to a company for working capital

- Where the petitioner's interests are adverse to those of the company.
So where the petitioner was the freeholder of land leased to the company which had security of tenure under the Agricultural Holdings Act 1986, the court refused to order possession of the land under s.994. [11]

PARENT AND SUBSIDIARY COMPANIES

16. Section 994 only applies where the affairs of the company are being conducted in a manner which is unfairly prejudicial. The section does not apply where another shareholder, even a majority shareholder , is conducting its own affairs in a manner which is prejudicial to the petitioner.

17. Nevertheless, where a parent company has detailed control over the affairs of a subsidiary and treats the financial affairs of the two companies as that of a single enterprise, actions taken by the parent in its own interest may be considered to be acts done in the conduct of the affairs of the subsidiary.[12]

18. Further, conduct of the affairs of a subsidiary may be conduct of the affairs of the parent eg where the directors of the parent represented the majority of the directors of the subsidiary.[13]

THE NATURE OF UNFAIR PREJUDICE

19. Ordinarily there will be no entitlement to complain of unfairness under s.994 if there has been no *"breach of the terms on which the [petitioner] has agreed that the affairs of the company should be conducted"*.[14]

Objective Test

20. The test for *unfair prejudice* is objective not subjective:

"... it is not necessary for the petitioner to show that the persons who have de facto control of the company have acted as they did in the conscious knowledge that this was unfair to the petitioner or that they were acting in bad faith; the test, I think, is whether

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[11] **Re JE Cade & Son** [1992] BCLC 213

[12] **Nicholas v Soundcraft Electronics** [1993] BCLC 360 CA

[13] **Gross v Rackind, Re Citybranch Group Ltd** [2005] BCC 11 CA

[14] **Re Saul D Harrison & Sons Plc** [1995] 1 BCLC 14

a reasonable bystander observing the consequences of their conduct, would regard it as having unfairly prejudiced the petitioner's interests."[15]

The Distinct Requirements

21. Prejudice and unfairness are distinct requirements:

- The mere fact that respondents have caused prejudice to the petitioner does not always mean that there has been unfairness. So where two companies were always run as a single unit in disregard of the constitutional formalities of both of them but with the acquiescence and knowledge of the petitioners there was prejudice but no unfairness.[16]

- Conversely, reprehensible conduct by those in control of a company may be unfair and reprehensible but not prejudicial. So where directors entered into transactions pursuant to which (despite obvious conflicts of interest) they purchased company assets, this was unfair but no s.994 remedy was granted as the price paid by the directors was not less than the company would have obtained from an arm's length purchaser.[17]

The need for substantial prejudice

22. Prejudice must be substantial relative to the remedy sought by the petitioner.

- In particular, a respondent will not be required to buy out the petitioner's shares at a fair price if the prejudice is relatively trivial and the petitioner has already accepted the role of a passive investor.[18]

- It has been held that in a quasi partnership company a *justifiable* loss of confidence by the petitioner in the other quasi partner which leads to a breakdown in the relationship may amount to sufficient prejudice even if there is nothing more tangible by way of prejudice[19], but a mere breakdown of trust in confidence among quasi partners will not be a basis for a successful petition- the breakdown must relate to conduct which is unfair

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[15] **Re Bovey Hotel Ventures Ltd** unreported but quoted and followed in **RA Noble & Sons Clothing Ltd** [1983] BCLC 273 at 290

[16] **Jesner v Jarrod Properties** [1992] BCC 807

[17] **Rock Nominees Ltd v RCO (Holdings) Ltd** [2004] 1 BCLC 439 CA

[18] **Re Metropolis Motorcycles Ltd** [2005] 1 BCLC 520

[19] **Re Baumler (UK) Ltd** [2005] 1 BCLC 92

and prejudicial.[20]

23. Prejudice is harm in a commercial and not merely emotional sense yet while it is helpful to a petitioner's case to show that the conduct complained of has caused a loss in the value of the petitioner's shares, this is neither a necessary or sufficient basis for a petition.

- It is not sufficient because conduct by the majority which is not unfair (eg commercial misjudgment) might cause a fall in the value of the shares.

- It is not necessary because there may be unfairness and prejudice from an exclusion from the management of a company.[21]

Unfairness & Legitimate Expectations

24. The Courts have used the concept of *legitimate expectations* to describe the types of interests that may be protected by a s.994 petition.[22] Members have a legitimate expectation that a company will be managed lawfully, ie in accordance with its articles and the duties of directors but where there is no illegality the task of identifying legitimate expectations is harder.

25. It has been held that "*Section [994] enables the court to give full effect to the terms and understandings on which the members of the company become associated but not to re-write them"*[23]

26. The existence of formal agreements does not necessarily prevent the existence of unwritten understandings giving rise to legitimate expectations but it does reduce their likelihood.[24]

27. In larger companies a legitimate expectation based upon informal arrangements supplementing the company articles will be difficult to establish and, even if established, unlikely to be given effect to by the courts. For example, in a case where a company was quoted on the Unlisted Securities Market it was said:

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[20] **Re Jayflex Construction Ltd** [2004] 2 BCLC 145

[21] **Re RA Noble & Sons (Clothing) Ltd** [1993] BCLC 273

[22] **Re a Company** [1986] BCLC 376, per Hoffman J.

[23] **Re Posgate and Denby (Agencies) Ltd** [1987] BCLC 8 at 14

[24] **Re a Company (2015 of 1996)** [1997] 2 BCLC 1

"Outside investors were entitled to assume that the whole of the constitution was contained in the articles, read, of course, together with the Companies Acts. There is in these circumstances no room for any legitimate expectation founded on some agreement or arrangement made between the directors and kept up their sleeves and not disclosed to those placing the shares with the public through the Unlisted Securities Market." [25]

Equitable considerations

28. Lord Hoffman in the leading case of *O'Neill v Phillips*[26] commented on his earlier use of the phrase *"legitimate expectations"* and said it was *"probably a mistake"* and that the phrase *"should not be allowed to lead a life of its own"*. His concern was to make clear that s.994 petitions did not give the courts a general power to assess the fairness of the conduct of company controllers. He said that he preferred to use the phrase *"equitable considerations"* to describe the circumstances when the courts should grant relief to petitioners. While this is a shift in language it is not a change of approach which is still almost contractual when the complaint concerns *legitimate expectations*.

29. Cases often use the language of equity and fairness. For example:

-Unfairness is to be judged *"by testing whether, applying established equitable principles, the majority has acted, or is proposing to act, in a manner which equity would regard as contrary to good faith"*. [27]

30. However, when assessing what is equitable a petitioner will normally need to prove the existence of agreements, promises, or understandings, reached among the shareholders at the time the company was established or subsequently and reliance on any such informal understandings.[28] Reliance at the time a company is established is likely to be easily established by the fact that someone chooses to invest money/ effort in the creation of a new business. Subsequent reliance may be harder to prove.

EXAMPLES OF UNFAIRLY PREJUDICIAL CONDUCT

Majority taking financial benefits from minority

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[25] **Re Blue Arrow** [1987] BCLC 585 at 590

[26] [1999] 1 WLR 1092

[27] **Re Guidezone Ltd** [2000] BCLC 321 at 356

[28] *ibid*

31. Where a majority shareholder arranges the company affairs so that he obtains unjustified financial benefits at the expense of the minority, eg by transferring to himself the business and thus depriving the minority shareholder of a share of profits, this is a strong basis for s.994 petition.[29]

32. A recent Court of Appeal judgment [30] has overturned a first instance decision that there was no unfair prejudice in circumstances where a majority shareholder/ sole director was paid excessive remuneration but had disclosed it in the accounts. The judge's conclusion that the director's excessive remuneration was not unfairly prejudicial because the minority shareholder could have found the information about the excessive remuneration by inspecting accounts was held to be wrong in principle since it involved a new restriction on the manner in which shareholders could enforce the liability of directors for wrongs to their company. The judge's approach meant that minority shareholders were at risk of losing their rights to enforce a director's liability to their company if they did not read their company's filed accounts. That imposed a requirement for diligence that had no basis in the statutory provisions or in principle or authority. The Court of Appeal also found additional unfair prejudice in this case because the director (albeit unprofitably) had used the company's trading name for his own business and the Court of Appeal said the company had lost the benefit equivalent to a hypothetical licence fee.

Exclusion from management

33. In a small company a shareholder does not have an automatic right to be involved in management issues. A breakdown in relations between members is an ordinary hazard of business and an insufficient basis for a petition. The courts have rejected the application of s.994 as form of corporate *no fault divorce* [31]

34. Nevertheless in small *quasi partnership* companies there is often an informal agreement or arrangement that the shareholders will be involved in the management of the company and a common basis for a petition is the removal of the petitioner from the board of directors. Recently the High Court has held [32] that the exclusion of a company member with a one third shareholding from the management of two *quasi partnership* companies was prejudicial and unfair but made clear that the general test for unfair prejudice was an objective one and not a subjective one. Further, it held that in the case of a small

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[29] **Re London School of Electronics Ltd** [1986] Ch 211

[30] **Geoffrey Maidment v Allan Attwood & Others** [2012] EWCA Civ 998

[31] **O'Neill v Phillips** [1999] 1 WLR 1092

[32] **Rheinallt Williams v Robin Williams & Others** LTL 12/10/11

quasi-partnership company, a shareholder did not have the automatic right to participate in the management of the company, but must not suffer any action or conduct by his co-quasi partners in breach of a clear understanding reached between them at the outset.

Excessive remuneration/ derisory dividends

35. Where a petitioner is no longer or never has been a director, a common cause of complaint is that the directors are paid excessive remuneration resulting in a diminished (or no) dividend. No special rules apply in this scenario. Shareholders, even in small quasi partnership companies, have no automatic right to expect dividends.[33] Specific additional circumstances need to be proven to satisfy the unfair prejudice test eg: an informal understanding that the profits of the company would be distributed in a particular way. Also, where one party is actively involved in running a business it may be fair that they receive more from the business than a purely passive shareholder.

36. In a recent decision [34] a minority shareholder was entitled to a remedy where a company had engaged in unfairly prejudicial conduct as it had departed from an agreement by decreasing the amount of funds available, and rendering itself unable, to pay the minority shareholder dividends due under the agreement. The facts were that two brothers who were shareholders agreed that one of them (who was a minority shareholder) would receive payment via an index linked dividend funded by a company's rental income paid by an associated company. The majority shareholder then procured for his own benefit a reduction in the rental payments so no dividend could be paid to his brother.

Serious Mismanagement

37. Ordinary commercial errors are not a proper basis for a petition, but *serious mismanagement* by a controlling shareholder has been held to be a basis for a successful s.994 petition.[35] What amounts to *serious mismanagement* as opposed to ordinary commercial errors has not been adequately explained by the courts.

38. Where mismanagement is of the self serving variety, such as where assets are used for the personal benefit of a majority shareholder that is a proper basis for a petition.[36]

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[33] **Irvine v Irvine (No 1)** 2007 BCLC 349 at 421

[34] **Sikorski v Sikorski** [2012] EWHC 1613 (Ch)

[35] **Re Macro (Ipswich) Ltd** [1994] 2 BCLC 354

[36] **Re Elgindata Ltd** [1991] BCLC 959

Prevention of sale of shares at higher value

39. A minority shareholder can be unfairly prejudiced by being prevented from selling his shares to the highest bidder.[37]

Criminal Conduct

40. The conduct of a company's affairs by the majority in a criminal way can amount to unfair prejudice.[38]

Removal of an auditor

41. Removal of a company auditor for an improper reason may amount to unfairly prejudicial conduct.[39]

REMEDIES

42. Section 996 of the Companies Act 2006 provides that. the court may make *"such order as [the Court] thinks fit for giving relief in respect of the matters complained of"*

43. The 2006 Act expressly sets out potential remedies such as:

- Regulating the affairs of the company by either altering its constitution or forbidding the alteration of its constitution

- Requiring the company to do or to refrain from doing an act such as the disposal of an asset.

- Authorising the bringing of proceedings in the name of or on behalf of the company (i.e. a derivative claim)

- Ordering the purchase of some of all of the shares in the company.

44. Key points to note are that:

- The courts have a wide discretion as to remedies.

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[37] **Re a Company (No 8699 of 1985)** [1986] BCLC 382

[38] **Bermuda Cablevision Ltd v Colica Trust Co Ltd** [1998] AC 198

[39] CA 2006 section 994(1A)

- The Court has to look at all the relevant circumstances when deciding what type of order to make.

- It has been said that the appropriate remedy is one which would *"put right and cure for the future the unfair prejudice which the petitioner has suffered at the hands of the other shareholders of the company"*. [40]

- The Court is not limited to reversing or putting right the immediate conduct which justified the making of the order. [41]

- The prospective nature of the jurisdiction is reflected in the fact that the court must assess the appropriateness of the remedy as at the date of the hearing and not as at the date of the presentation of the petition and may even take into account conduct which has occurred between those two dates. The Court is entitled to look at the reality and practicalities of the overall situation, past, present and future.

Orders for the purchase of shares

45. Where a court orders the purchase of shares this usually involves the purchase of the petitioner's shares by the other shareholders. Valuation questions are often the focus of much of the litigation:

- Minority shareholders can often expect their shares to be valued at a discount to reflect the lack of a controlling interest but this should not apply to *quasi partnership* companies. [42]

- It is sometimes but not necessarily the case that a break up valuation rather than a going concern valuation is appropriate. [43]

- Where unfairly prejudicial conduct has damaged the value of a petitioner's shares then a buy out can be ordered based on historical valuations or on the hypothetical basis that such conduct has not occurred.

Relationship with Derivative Claims

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[40] **Re Bird Precision Bellows Ltd** [1986] Ch 658 at 669

[41] **Grace v Biagioli** [2006] BCC 85

[42] **Irvine v Irvine (No 2)** [2007] 1 BCLC 445

[43] eg **Shah v Shah** [2011] EWHC 1902 (Ch)

46. So long as the petitioner seeks only personal relief (eg to be bought out) , the use of s.994 where the majority shareholder has acted in breach of duty to the company is not problematic. However, even if the petitioner also seeks corporate relief (eg it wants a derivative claim to be brought) this can be achieved by s.994.[44]

47. Many petitions are founded on conduct which consists of wrongs done to the Company where the petitioner is unable because of the rule in *Foss v Harbottle* and the prohibition on the recovery of shareholder's reflective losses to bring a claim. In such circumstances a 994 Petition can be a useful alternative way to bring a derivative claim. While proceeding by s.994 may avoid the formalities of a statutory derivative action a petitioner should not expect the court to take a less vigorous approach to the question of whether a derivative claim is appropriate.

48. In a case where a derivative action had been brought, a shareholder was given leave to join an unfair prejudice petition to the derivative action but the derivative action was then stayed in favour of the petition since this enabled all the proceedings between the parties to be decided at a single trial.[45] Such an approach is convenient where the petition is based in part on allegations of breach of duty on the part of the majority and in part on allegations of mere unfairness.

Relationship with Just and Equitable Winding Up

49. Section 122(1)(g) of the Insolvency Act 1986 provides the drastic remedy of winding up a company on just and equitable grounds. A winding up petition should not be issued in conjunction with a 994 petition unless the petitioner has a genuine intention to seek the winding up of the company. If unfair prejudice under s.994 cannot be established then *just and equitable* winding up will not be available either.[46] Note that a just and equitable winding up petition engages s.127 of the Insolvency Act 1986 (restriction on post petition dispositions by the company).

PRACTICE AND PROCEDURE

50. Relief under s.994 requires a petition otherwise it will be struck out. Failure to proceed by petition is not a defect in procedure that can be remedied under the CPR.[47]

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[44] **Bhullar v Bhullar** [2004] 2 BCLC 241

[45] **Cooke v Cooke** [1997] 2 BCLC 28

[46] **Re Guidezone** [2001] BCC 692

[47] **Bamber v Eaton** [2007 BCC 272

51. The Company will often be named as a respondent alongside the majority shareholder. This is essential if some remedy is required against it such as a purchase of shares by the company or the sale of a company asset. It may also be necessary to join all the other shareholders.

52. It is not necessarily appropriate for the majority shareholder to be represented by the same solicitors as the company.

53. No limitation period applies to s.994 petitions but the court is likely to refuse to grant relief if there is excessive delay.[48]

54. In appropriate cases, summary judgment or a strike out may be available. Within this category would be cases where a detailed shareholder agreement includes an entire agreement clause negating any contrary understanding, or there is a relevant arbitration clause or other dispute resolution mechanism[49].

55. The costs arising from unfair prejudice petitions are often substantial. They do not attract any special principles and appropriate regard will be had to early offers to settle / mediate etc. If a petitioner succeeds in establishing unfair prejudice on only some of the various allegations then this may be reflected by a reduction in the recoverable costs. [50]

Conclusions

56. With the benefit of hindsight most s.994 disputes could have been avoided if the parties had entered into appropriate shareholder agreements. The saving of modest corporate lawyers' fees at the time of incorporation often results at a later stage in substantially greater expense on litigation lawyers.

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[48] **Re Grandactual** [2006] BCC 73, where relief was refused in respect of events 9 years before

[49] see **Dalby v Bodilly** [2005] BCC 627 & **Hawkes v Cuddy** [2007] EWHC 1789

[50] **Southern Counties Fresh Foods Ltd v RWM Purchaser Ltd & Others** [2011] EWHC 1370 (Ch)