Guide to the law relating to shareholder disputes

This is an overview of the underlying law and remedies which are applicable to boardroom disputes and shareholders disputes.

The law that underlies most boardroom disputes and shareholders disputes is complex and technical. As well as key statutes such as the Companies 2006 and Insolvency Act 1986 it is based on decided cases going back many decades.

This guidance note outlines the key legal concepts that are relevant to the resolution of any such dispute. It looks at the various remedies available to shareholders including the most widely used statutory "unfair prejudice" remedy.

In order to appreciate the nature of the legal remedies available it is first necessary to understand some underlying legal concepts.

The legal nature of companies

A company is a separate legal entity, distinct from its directors and shareholders. This means, amongst other things, that a company may sue, or be sued by, its directors and/or shareholders. In many cases the company is the only possible claimant in relation to wrongdoing that has occurred. Accordingly, a key question in relation to understanding any boardroom dispute or shareholders dispute is – who controls the company?

The key document which sets out the balance of power within a company is the Articles of Association of the company ("the Articles"). These are in effect a binding contract between the company and its shareholders. Subject to any overriding company law the Articles determine who within a company exercises which powers on its behalf.

Some companies may also have a shareholders agreement, which is a separate contractual agreement between shareholders setting out their rights and responsibilities as shareholders. Such documents can contain very detailed arrangements covering for example, day to day management of a company, rights of specific shareholders and exit routes for shareholders both voluntary and compulsory.

The position of directors

Directors generally have the day to day control of the company under the Articles. This means the right to make decisions for the company including whether or not to enter into any contract, or to raise finance or take any other steps in relation to the management of the company.

Generally the board of directors must act as a majority and subject to any quorum specified in the Articles any decision simply requires a majority vote.

The rights of directors may be restricted by the Articles themselves or, particularly in owner managed companies, by a shareholders agreement governing, for example, what decisions require some form of shareholder approval.

Directors have numerous duties to the company under common law and pursuant to the Companies Act 2006.

In very brief summary – these duties require directors to act in good faith and with the interests of the company in mind. It is often the breach of these duties which gives rise to boardroom or shareholders disputes.

The key thing to note about such a breach is that as a rule the right to bring a claim against directors who are acting wrongfully belongs to the company itself and not to the other directors or shareholders.

The position of shareholders

Although directors have the day to day control of the company, shareholders hold the ultimate power. By majority vote shareholders can dismiss directors and can appoint new directors to the board (although these powers are often restricted by the Articles or in a shareholders agreement).

By taking control of the board of directors a shareholder will then be able to force the company to take the desired action (which might include a claim by the company against a director guilty of some wrongdoing).

However, this ultimate power does not assist an unhappy shareholder where they are a minority shareholder. In that case the shareholder must rely upon one of the remedies below if the majority shareholders are in control of the company via the directors.

The statutory rights of shareholders

Shareholders do have certain statutory rights that can be of assistance. These include the right to inspect company registers and to require the company to call general meetings. Sometimes exercise of these rights can be sufficient to defuse a dispute if the issues are brought out into the open and discussed at a shareholders meeting.

Personal claims by shareholders

Shareholders also have some personal rights. These include:

- the right to enforce rights conferred by the Articles (for example where the directors act or propose to act contrary to the Articles),
- the right to object to an improper alteration of the Articles,
- the right to bring an action to prevent a proposed ultra vires transaction (i.e. a transaction that is outside the power of the company or its directors).

If there is a shareholders agreement in place then the shareholder may also have remedies under this which are enforceable against the signatories of the agreement in the same way as any other contract.

In the event that these remedies do not assist then a disgruntled minority shareholder has two choices:

- consider whether they may be entitled to bring a claim on behalf of the company (against, for example, a wrongdoing director), or
- rely upon the statutory protection that is available to minority shareholders.

The best route will depend upon the facts of each individual dispute.

Derivative claims

Shareholders have long been able to bring a claim in the name of a company against those guilty of wrongdoing but this right was very restricted. In essence it was possible where the wrongdoing amounted to an “equitable fraud" against the company and the wrongdoers were in control of the company.

The claim is brought by the shareholder in the name of the company and is called a derivative claim because the shareholders' right to claim derives from the company's right to claim. One important point to note is that the proceeds of any claim belong to the company and not the shareholder.

A new statutory derivative claim was introduced by the Companies Act 2006. This has made the remedy less restrictive in scope but introduced a two stage process, the first stage of which is to obtain the permission of the court. In practice this remedy is unlikely to be the most attractive route to resolve most disputes and minority shareholders will probably look instead at the other statutory remedies that are available.

Just and equitable winding up

Under S.122(1)(g) of the Insolvency Act 1986 a company may be wound up by the court if: "the court is of the opinion that it is just and equitable that the company should be wound up".

Where relations between directors / shareholders have hit rock bottom then this is really the nuclear option.

A shareholder is entitled to apply for such a winding up where they have a sufficient interest in the winding up. This means in practice that a fully paid up shareholder must show that there will be a monetary surplus after winding up for distribution amongst the company's members. There is also a requirement in most instances that shares have been held for at least 18 months (S.124(2)(b)).

There is no easy definition of what circumstances make it "just and equitable" for a court to wind up a company. Each case is looked at on its own merits.

Situations where winding up orders have been made include where:

- a minority shareholder was wrongly excluded from management;
- the majority shareholders have consistently ignored the rights of the minority;
- the directors have awarded themselves excessive remuneration whilst refusing to pay dividends to shareholders;
- there is deadlock within the company and no decisions are capable of being made.

It should be noted that this is an equitable remedy which is in the court's discretion. This means that a person seeking the remedy must come to the court with "clean hands". If they are partially the author of their own misfortune as a result of their own actions then the court is much less likely to assist.

The other critical point to note is that even if a case for winding up on equitable grounds is clearly established the court may refuse to grant the relief on the basis that there is an alternative remedy and it is unreasonable for the complainant not to pursue that remedy (s.125(2)). A court is unlikely to relish winding up an otherwise healthy company and will therefore look closely at such alternatives before granting an order for winding up.

Alternative remedies can include an offer by the respondents to buy the complainant's shares at a fair value or the fact that the complainant might have a more appropriate remedy under s.994 of the Companies Act 2006 (see below).

Unfair prejudice – the statutory remedy

The most powerful weapon in the armoury of an aggrieved minority shareholder is the statutory remedy available under s.994 of the Companies Act 2006.

A shareholder may petition the court where the affairs of the company are being conducted in a manner that is unfairly prejudicial to all or part of its members.

There is no simple definition of what constitutes "the affairs of the company" or "unfair prejudice" and a large body of case law has developed over the years. Whilst the remedy is currently contained in the Companies Act 2006, it was originally contained in s.459 of the Companies Act 1985 and its roots can be traced back to a similar version appearing in the Companies Act 1945.

The four examples of what might be grounds for winding up on just and equitable grounds that are cited above are also typical grounds for the court to find that unfair prejudice has been established. However, the terms "the affairs of the company" and "unfair prejudice" are considered by the court to be "general words" and the court has a wide discretion in their application.

For this reason there is no definitive list of what amounts to unfair prejudice but other situations where unfair prejudice has been found include:

- a failure to consult the complainant or to provide information;
- misappropriation of company business or assets;
- mismanagement of internal company affairs;
- the failure to pay reasonable dividends;
- improper allotments of shares and rights issues.

One key point to note is the equal weighting given to the two words. No matter how "prejudicial" certain actions may be, a complainant will only have a remedy if the actions are found to be "unfair".

A typical scenario might arise in a company which lawyers describe in shorthand as being a "quasi-partnership". What is meant by this is a company where there are certain understandings or expectations between the members which go beyond their strict legal relationships. In such a case the exercise of strict legal rights that adversely another member, whilst wholly proper as a matter of law, may be seen as "unfair" for the purposes of the statute.

Another point to note is that s.994 does not provide a mechanism for "no-fault divorce". Without the key element of "unfair prejudice" being present a party's petition to the court will inevitably fail.

Unlike a petition for just and equitable winding up, a petition under s.994 does not require a complainant to come to the court with "clean hands". However, the absence of clean hands is something that the court may have regard to and may, in particular, affect the sort of remedy it is willing to grant.

In terms of remedies the court has a very wide discretion under s.996 of the Companies Act 2006 which states that "if the court is satisfied that a petition ... is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of".

The section goes on to list various possible orders including an order for the shares of any party to be purchased by another party or the company itself. The purchase of the complainant's shares by the wrongdoers is the most commonly sought and granted remedy.

If such an order is made then it is necessary to consider the valuation of the shareholding and this is itself fertile ground for disputes.

Often, and particularly in "quasi-partnership companies", shares will be valued without a discount (in other words, pro rata to the value of the entire shareholding). However, where this would result in an unjustified windfall for the shareholder the court may apply a discount to reflect the true commercial value of a minority holding.

Other adjustments may also be made to any valuation to ensure that it is a fair one. This may include, for example, adding back in the value of excessive remuneration paid to a majority shareholder or taking into account other wrongful acts that have reduced the value of the company.

A point to note is that the fact that a party may not be able to afford to buy out the shares at this value will not prevent the court making such an order.

Other factors that may affect the amount paid for the shares include the date on which the valuation is made. This can have a significant impact on the overall valuation and the court has a wide discretion to determine the appropriate date having regard to all the circumstances. The most usual date for the valuation is the date on which the shares are ordered to be purchased.

Summary

As noted at the beginning of this guide, the law relating to boardroom and shareholders disputes is a complex and technical area.

Boardroom disputes and shareholders disputes revolve around their own facts and battles can be won or lost based on tactical decisions made at the outcome. Accordingly, in the event of such a dispute it is recommended that formal legal advice from a lawyer with expertise in this field is sought at the earliest opportunity.

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