# Excessive directors' pay and unfair dividends in family businesses

*This article has been reviewed and is up to date as of 10 June 2020.*

Owner / managers of family businesses are entitled to be paid for their management role but this pay must not be unfair in relation to other family shareholders.

A common situation, especially in family companies, is that there will be shareholders who have management roles and shareholders who do not.

There is often also an expectation that the company will, by payment of dividends, provide an income to the wider shareholders. However, as time goes on the strength of this expectation can often be reduced, especially for subsequent generations of family shareholders.

In most family companies the shareholders and directors will agree a fair split of profits. This can be achieved in different ways.

In some companies the shares may be split into different classes and different levels of dividends paid for each class relating to wider contribution to the company from the members in that class. In other words, those who are the managers get bigger dividends.

Alternatively, where there is only one class of shares then managers may be rewarded by payment of salaries, such payments then dictating what profits are available for pro rata distribution via dividends to the wider family shareholders.

## When interests conflict

However, there is always the risk that the interests of the managing family members and the non-managing family members will diverge.

This can be because the family members involved in the business come to resent financially supporting those who are not contributing to the business. Or the non-managing family members may oppose expansion or investment of profits in view of their focus on receipt of dividends, causing frustration and conflict.

Sometimes it is just because two branches of a family fall out. In those situations the managing family members may use their powers on the board of directors to increase their salaries and / or reduce dividends payable (either generally or to a specific class of shares).

In the absence of a shareholders agreement regulating this or restrictions in the articles of association of the company, what can the other family members do?

If they hold the majority of the shares then they may be able to remove and add directors to change the board. However, often the managing family members control a majority of the shares which means that this is not possible.

## Where does this leave the non-managing family members?

The starting point is that in the absence of an agreement between them shareholders do not have a legitimate expectation of being paid dividends. The directors can quite properly decide that it is in the interests of the company to not pay dividends.

In family companies there will often be a clear understanding that dividends will be payable to distribute wealth across the family. Breach of this understanding can amount to unfairly prejudicial conduct towards minority shareholders enabling a claim to be brought under s.994 of the Companies Act 2006.

However, the more commercial a company becomes and the more distant shareholders are from being involved in management, the more difficult it may be to persuade a court that there is an agreement or understanding which binds the shareholders (in the absence of a formal shareholders' agreement to this effect).

## A case in point

A 2017 case illustrates how the court can still assist in this regard.

The company in question was a family owned recycling business. The directors were the majority shareholders. Over a long period the company stopped paying any dividends, the directors' salaries increased to well above any reasonable market rates and the directors used company money to purchase a fleet of luxury cars and a yacht to which they, but not the minority shareholders, had access to.

The minority shareholders did receive offers to buy them out but these offers were well below any realistic market valuation of their shares.

The minority family members petitioned the court under s.994 of the Companies Act 2006. They claimed that the actions of the majority family members were unfair due to their excessive remuneration and failure to pay dividends.

The court found that the minority family members had been unfairly prejudiced as the directors had breached their duties under the Companies Act 2006 in relation to both their remuneration and the policy not to pay dividends.

These duties, as summarised by the Judge, were:

- To exercise the power to recommend or not recommend a dividend for the purposes for which the power was conferred (section 171(b) of the Companies Act 2006)
- To reach the conclusion (dividend or no dividend) that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (section 172 of the Companies Act 2006)
- To exercise independent judgment (section 173 of the Companies Act 2006)

The Judge held that what the majority family members did was in their personal interests and not the interests of the company. As a result, they were ordered to buy out the minority family members at a fair value.

While the facts of this particular case were quite extreme, it is clear that the court can step in where directors who are also majority shareholders turn off the dividend tap by increasing their salaries to a level that cannot be justified by the interests of the company. This will amount to a breach of statutory duties, and therefore will be unfairly prejudicial to the minority shareholders.

One further point to note in this case is in relation to the valuation of the minority shares. Whilst this was a family company, it was not held to be a 'quasi-partnership'. This is likely to be the position generally where minority shareholders take no active role in the business.

The importance of this is that in a quasi partnership company the general rule is that shares will be valued on a pro rata basis without any discount to reflect their minority status (thus departing from the normal commercial position in terms of valuation).

In this case the Judge held that a 'fair' valuation of the minority's shareholding required a 33% discount to reflect the minority status.

The better news for the successful minority family members was that the court ordered that in valuing the company on a balance sheet basis, the excessive remuneration that it was found to have been paid should be added back in arriving at a value.

The case referred to above is [2017] EWHC 457 (Ch) – In the matter of CF Booth Ltd.

## How we can help

If you'd like advice on resolving a dispute concerning a family business, please contact our commercial disputes team.

Written by

Ed Weeks

Partner and Head of Corporate