Boardroom and shareholder disputes can arise for many different reasons eg. arguments over the development and direction of the business, fractured personal relationships, people spending time on other businesses (sometimes in competition).

Tensions also frequently arise between directors who wish to pay themselves high salaries or keep funds locked into the company and shareholders who feel that their interests are being ignored and give some practical tips on trying to avoid and resolve shareholder disputes.

Avoiding disputes
A shareholder’s rights are primarily governed by the company’s Articles of Association and the Shareholders’ Agreement (if there is one). Our top tip on avoiding a shareholder dispute is to seek advice on the incorporation of the company on putting in place bespoke Articles and a Shareholders’ Agreement to record the intended rights and obligations of shareholders and to provide agreed exit provisions in the event that agreements arise. These normally include pre-emption rights which provide a mechanism for the lessor’s shares to be bought out at a fair price.

Unfair prejudice
If there is no Shareholder’s Agreement providing assistance then what can minority shareholders do? They do not have the voting rights to assert direct control over the company’s affairs.

The Companies Act 2006 provides aggrieved minority shareholders with a potential remedy in the form of a section 994 or “unfair prejudice” petition. A shareholder must show that the company’s affairs are being conducted in a manner that is unfairly prejudicial to some or all of the shareholders in that company (including him or herself).

It is necessary to prove that conduct complained of is both unfair and prejudicial – proving one or the other is not enough. Commercial decisions will often impact different shareholders to varying degrees and the mere fact that a decision adversely impacts a minority shareholder will not, without more, give rise to a claim. The court will not grant relief just because the company is ‘deadlocked’ or the trust and confidence between the shareholders has broken down.

To succeed, a shareholder will have to identify either some breach of rules or the agreement as to how the company should be run. Alternatively, if the rules have not been breached, shareholders would have to show they have been applied without good faith in a way that would make it unjust for the controllers of the company to rely on their strict legal powers. It is not strictly necessary to establish deliberate bad faith, but this will often form the basis of the allegations.

Examples of unfair prejudice
Unfair prejudice claims are very fact specific and will be determined by reference to the particular company in question and the agreement and expectations between its shareholders. However, actions which the courts have found to be unfairly prejudicial include:

• Excluding a shareholder from the management of a quasi-partnership;
• Diverting business away from the company;
• Failing to pay proper dividends;
• The majority shareholder awarding himself excessive remuneration or using the company for his own personal benefit;
• Allotting shares in breach of pre-emption rights or the deliberate dilution of a minority shareholders;
• Serious accounting failures;
• Allotting shares in breach of pre-emption rights or the deliberate dilution of a minority shareholders;
• Serious accounting failures;
• Allotting shares in breach of pre-emption rights or the deliberate dilution of a minority shareholders;
• Serious accounting failures;
• Failing to obtain shareholder approval for the sale of company property to its directors;
• Serious breaches of the company’s Articles (technical breaches of limited consequence will not be enough).

The Remedy
If unfair prejudice is established, the court has wide ranging powers to regulate the company’s affairs or order it to be wound up. However, by far the most common remedy is for the other shareholders and/or the company to buy the minority shareholder’s shares at a “fair value”.

A fair value of the shares will be determined by an expert but with two benefits to the minority shareholder. Firstly, the expert will ignore the effect of any unfairly prejudicial actions which could reduce the value of the shareholders. Secondly, the value of the shares will be calculated pro rata without any discount for a minority shareholding. As a result, the fair value of the shareholding may be significantly higher than its open market value.

Quasi-Partnership
In many private companies, the directors and shareholders are the same people and there is no significant separation of ownership and management. ‘Quasi-partnerships’ are companies which are formed or developed on the understanding that the members will participate in the management as well as the profits of the company. A quasi-partnership may exist where the relationship between shareholders involves mutual confidence, for example because of the personal relationship between the shareholders or on the incorporation of a priority partnership.

As the name suggests, a quasi-partnership is run in practice as a partnership and subject to a “quasi-partnership agreement” (whether or not legally binding) and/or equitable considerations of fairness between partners. These considerations may prevent the majority shareholders exercising their strict legal rights without giving rise to an unfair prejudice claim. In particular, shareholders cannot ignore a legitimate expectation of involvement in management to remove a quasi-partner from office without making a fair offer (ie: not market value with minority discount) to buy out their shareholding.

Unfair prejudice claims are not limited to quasi-partnerships but where a company is not a quasi-partnership it will be difficult to show any limitation on the members’ strict legal rights. Accordingly, to succeed, a minority shareholder would need to establish some abuse of powers or breach of the Articles or companies legislation.

Practical Considerations
• Minority shareholders do not need to establish illegality or breach of the company’s constitution to bring a claim. An action may be permitted by the articles but still be unfairly prejudicial.
• Unfair prejudice issues cannot be considered in isolation. Minority shareholders may also have employment claims, contractual claims for breach of a shareholders’ agreement or a derivative action on behalf of the company.
• Minority shareholders claiming unfair prejudice should be willing to part with their shares. A section 994 petition is intended to give an aggrieved shareholder a “way out” on fair terms. It is not designed to give minority shareholders any control over the company or to undo the majority shareholders and directors.
• Always consider your tax position – could any payment be made in lieu of notice if you are an employee and your contract allows for this? Can any part of the payment be tax free as compensation for loss of office? Will you be eligible for entrepreneur’s relief to reduce your capital gains tax liability?
• Be prepared to consider mediation or other form of resolution at an early stage to see if any resolution short of litigation and/or an exit from the company can work for you.
• If your shares are to be bought out seek early expert advice on the valuation of your shareholding.
• Shareholder disputes consume time and money, and are a major distraction from running the business. Therefore take early advice to try to resolve these disputes, and remember that you cannot use company money to fund shareholder disputes, as that can amount to an act of unfair prejudice.

For further information or assistance in drafting Shareholders Agreements and Articles, please contact Malcolm Sadler partner in the commercial team at Henmans Freeth on 01865 781058/malcolm.sadler@henmansfreeth.co.uk.

If you want advice on a shareholder dispute please contact either Clare Bellis, Senior Associate or Andrew Dashwood-Begg, Solicitor in the Dispute Resolution team on 01865 781021/andrew.dashwoodbeg@henmansfreeth.co.uk.

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