fact sheet

Shareholder Disputes: The Do's and Don'ts

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Preliminary

This fact sheet is concerned with the legal issues surrounding shareholder disputes: it highlights key issues, problem areas and tactics.

But the legal issues are likely to be only a part (perhaps a relatively small part) of the mix. The dispute may be centred on a cash flow problem which results from fundamental business issues that need to be addressed. There may also be a personality clash amongst the management or differences of opinion on strategy.

Those unfortunate enough to be involved in a shareholders' dispute need to find advisers who can consider the people and business issues first, before they turn their minds to how to help those involved to achieve a workable solution. The family shareholders' dispute is often the most intractable. Here the corporate legal advisers need to work closely with the family's trusted professional advisers.

Terms shown *in italics* are explained in the Glossary below.

The starting point: do your homework

Whenever a shareholders' dispute arises, those advising the shareholders need to be well prepared. The starting point is an examination of the Statutory Registers, otherwise known as the Statutory Books. This establishes ownership of the company and may include crucially important minutes and resolutions. The Articles of Association (which set down the constitution of the company) and any Shareholders' Agreement must also be carefully scrutinised. The Articles may incorporate the old *Table A* provisions of company law or the new Model Articles published in October 2009 following the final implementation of the Companies Act 2006.

Why are the Statutory Books so important?

It is the Statutory Books that determine who the members are: and it is only the legally recognised members who can exercise the voting rights attached to the shares.

Each company must keep these books which should contain a Register of Directors (and Secretary if one is appointed), the Register of Allotments and Register of Members. These should be checked to verify the identity of the shareholders and the number and class of shares held. Errors in the Register of Members may give a right to a court action for *rectification* but until the records are changed those entered in the Registers are the persons entitled to vote. The minute book of the Board and General Meetings is usually at the back of the Statutory Books.

What if I am not allowed to inspect the Registers?

The members of the company have the legal right to inspect the Statutory Registers including the Register of Members: see section 113 Companies Act 2006. An offence is committed by the Company and its officers if there is a default in making available the Registers.

The Statutory Registers of private companies are frequently not properly maintained and the inspection may give surprising results.

What should I be looking for in the Articles?

You need to know how many directors must be present for a Board Meeting to be held and how many members must be present for a meeting of the members. Without that specified number being present the meeting will be *inquorate* and so legally ineffective.

You will also need to check whether there are any special rules for appointing and removing directors. Sometimes the Articles give a person who holds a specified proportion of the shares the right to appoint and remove one or more directors.

The general law provides that a director may be removed by an *ordinary resolution*. This is a resolution passed by a simple majority of the shareholders.

Remember that it is the Board who manage the business of the company and the members who can hire and fire the Board.

What else might I be looking for?

The Articles of Association of older companies may contain retirement by rotation provisions meaning that at each Annual General Meeting one-third of the Directors must retire by rotation. This was the standard default position under Regulation 73 of Table A of the Companies (Tables A to F Regulations) 1985 as amended.

Whilst it was common practice to amend this Table A provision, the standard Articles used by many company formation agents did not exclude Article 73.

Here lies a potential hidden trap which could be significant because Article 73 provides that at the company's first Annual General Meeting all the Directors were required to retire. However, many small private companies neglected to hold Annual General Meetings including the first which was required to be held within 18 months of incorporation. Case law has established that in such cases the entire Board will have ceased to hold office at the expiration of the 18 month time limit.

Whilst private companies are no longer required to hold AGMs this may be a hidden defect in the affairs of the company which could be of real significance legally if the shareholders fall out and where there are equal shareholdings.

The final enactment of the Companies Act 2006 (in October 2009) saw the introduction of a new Model Form of Articles for private companies which replaces Table A and does not include retirement by rotation. The Model Form will not, though, apply to companies incorporated before the Model Form was adopted as the default set of

Articles. Also this will be a pre-existing defect which can be remedied only by the current members.

What else might the Statutory Books reveal that could be significant in a shareholder dispute?

It may sometimes be critical whether one person has been appointed Chairman and has a casting vote at Board and General Meetings. This should be revealed by an examination of the minute book of Board and General Meetings.

Whilst the minute book of Board Meetings is open to inspection only by the Directors, the minutes of General Meetings should be available for inspection by the members.

Signed minutes are evidence that a resolution was passed.

So how does a casting vote work?

The Articles will generally provide that any Chairman of the Board has a second or casting vote at Board Meetings. With a deadlocked or split Board this could be crucial to effective decision making.

For votes at General Meetings, pre-October 2007 incorporated companies will (unless they choose otherwise by adopting amended Articles by special resolution) retain a Chairman's casting vote on resolutions put to shareholders at a General Meeting. Post-October 2007 incorporated companies will be subject to section 282 Companies Act 2006. This stipulates that an ordinary resolution is passed by members holding a majority of the voting shares: so here if the votes are split 50/50 there will be deadlock which cannot be broken by the *Chairman's casting vote*.

Remind me why the passing of an ordinary resolution is so important?

A company is managed by its Board of Directors and a director can be removed by ordinary resolution of the members.

The Act in fact stipulates that 28 days' notice (so called special notice) should be given to remove a director. (It should be noted that this is notice to the company not the director). Please see the separate Everyman Legal fact sheet "Removal of Directors".

It should also be remembered that those who control the Board can terminate the employment contract of any Board member. So whilst the removal of a person as Director can take 28 days or more, employment can be ended immediately.

Such termination may give rise to employment claims including unfair dismissal. Typically these are not significant where there is a major dispute. What may be significant is the possibility of a claim for unfair prejudice under section 994 Companies Act 2006. We deal with this in the section below.

What is a Shareholders' Agreement and how might things be affected if we have one?

The Shareholders' Agreement will add to or alter the constitution of the company established by the Articles of Association. It may stipulate matters that require the consent of a specified proportion of members even if the Articles would otherwise give the Board, or a certain proportion of members, a right to make that decision. So instead of a 50.1% or 75% vote in favour by the members a higher percentage may be stipulated.

Remember that whilst such an agreement may impose binding obligations on the members it may not be possible to fetter the actions of the company acting through its directors. Whilst no-one wants to break their legally binding promises a director's fiduciary duties means he may have competing legal obligations.

A shareholder looking to enforce promises in the Articles or Shareholders' Agreement may also be faced with the practical challenge of proving his loss for a breach of contract. This may represent a formidable hurdle if the action to be taken is demonstrably in the best interests of the company. In such circumstances a minority shareholder may need to contemplate legal proceedings and an interim order to prevent a decision being taken.

What about buy-back clauses?

A Shareholder's Agreement or the Articles may contain the right for those who control a company to compel a departing employee-shareholder to sell his shares.

These buy-back arrangements may distinguish between *good leavers* and *bad leavers* with significantly different prices to be paid for the shares of the leaver depending on the category into which he falls.

A company with such clauses in its constitution will be in a strong position to resolve satisfactorily a dispute with a minority employee-shareholder but only if it has the funds to buy out the shareholder. The arrangements may, though, be open to legal challenge. A determined and well advised minority shareholder may be able to negotiate a more advantageous exit.

Abuse by majority shareholders: unfair prejudice actions

We have seen that the holders of the majority of the shares are in a powerful position. We must now consider the rights of minority shareholders.

Section 994 of the 2006 Act allows a member to apply to the Court for an order that the affairs of the company are being conducted in a manner unfairly prejudicial to his interests.

If such a claim is successful made, the usual order of a Court will be that the minority shareholder be bought out for *fair value*. However, the Court has a very wide discretion as to what it can order and other orders are possible.

When might a Court find unfair prejudice?

The classic case of unfair prejudice will be where two or more individuals have set up a company together. In such cases there may be a mutual expectation of continued employment such that the Court will decide a *quasi-partnership* exists and that termination of that arrangement gives rise to an obligation to buy out the shares of the member whose employment has ended.

Since the usual long term solution to a falling out is that one person buys out the other that might not seem to much of a worry. Indeed a Court will generally stay (or put "on hold") legal proceedings under section 994 if the respondent issues an undertaking to buy the shares of the applicant at fair value.

However, such an analysis is to ignore the tactics of any dispute and the fact that the valuation of private companies is a very inexact affair. Wildly differing values may be produced depending on whether the valuer is acting for a buyer or a seller.

So the well advised majority shareholder should still strive to rebut the argument that there was a quasi-partnership or any unfairly prejudicial conduct.

In the event that the Articles contain buy-back provisions with a *call option* in favour of the company or the continuing shareholders (see above) the minority shareholder may seem to be in a weak position. However the company and the majority shareholders may not have the resources to buy out the departing executive. This may give considerable scope to negotiate better terms.

What other grounds might support an unfair prejudice claim?

The most obvious examples would be majority shareholders paying themselves excess remuneration or declining to pay dividends. There might also be claims of breach of duty by directors who divert a corporate opportunity into their own names or sell or buy assets at an unfair price.

There may also be complaints of failure to follow company law (e.g. the issuing of annual accounts) or proper procedure on meetings.

Are there any tips in relation to section 994 proceedings?

The first tip is that section 994 proceedings are very frequently threatened but the threats very rarely lead to legal proceedings. This is for the very good reason that these proceedings can be very costly and highly disruptive to the management of a small company. So if acting for the majority do not allow yourself to be bullied by an aggressive minority shareholder.

The second tip is that even if legal proceedings are issued they generally do not go to a full hearing. They are frequently settled on an interim application (e.g. where one side seeks an interim injunction to stop some corporate action). However, experience suggests that those in dispute should strive to settle any dispute amicably. Legal proceedings once issued can lead to entrenched positions, making a resolution much more difficult to achieve.

The third tip if you are unlucky enough to be on the receiving end of issued proceedings is to consider a tactical offer to buy shares at fair value. This assumes, of course, that you and/or the company have the resources to do so.

What about the costs of section 994 proceedings?

The Courts will not allow the company's own funds to be used to fight a legal battle that is essentially one between the shareholders. So even if advising the majority shareholder a personal rather than a corporate retainer will be needed if legal proceedings are issued.

Conclusion

Shareholder disputes are amongst the most challenging areas of work for legal advisers. The key for the shareholders will be to involve experienced and skilled advisers who are looking to find solutions that reflect the business issues first and the personal objectives second.

Beware of advisers who cannot see or do not care about the bigger corporate picture.

Glossary of Terms

Bad leaver: an employee–shareholder who leaves employment in circumstances where shares may be acquired at less than their fair value.

Call option: the right to buy the shares of a person which may be triggered by that person ceasing to be employed. This could be at a pre-agreed price or by reference to a third party valuation.

Chairman's casting vote: the right for the chairman of any meeting to have a second vote in the event of a tied vote. This right can be exercised at a Board Meeting if directors' votes are equal. It may also be exercised at a shareholders' meeting but not for a company incorporated after 1 October 2007.

Fair value: the market value of a share but with no discount applied by reason of the shares representing a minority interest. Under ordinary principles of valuation, shares representing less than 50% may be ascribed a lower value per share. The same principle may apply to a small minority shareholding that cannot block a *special resolution* (i.e less than 25%).

Good leaver: an employee–shareholder who is entitled to be paid fair value for their shares if they cease to be employed.

Inquorate: a meeting that lacks a *quorum.*

Model Articles: these were introduced following the enactment of the Companies Act 2006 and set down a standard constitution for a private company and a public company incorporated after 1 October 2009. A company is free to modify the Model Articles provided the amendments comply with the Companies Act 2006.

Ordinary resolution: a resolution passed by the holders of a majority of the voting shares.

Partners: the relationship between two or more persons in business together and where there will be a mutual duty of confidence and trust.

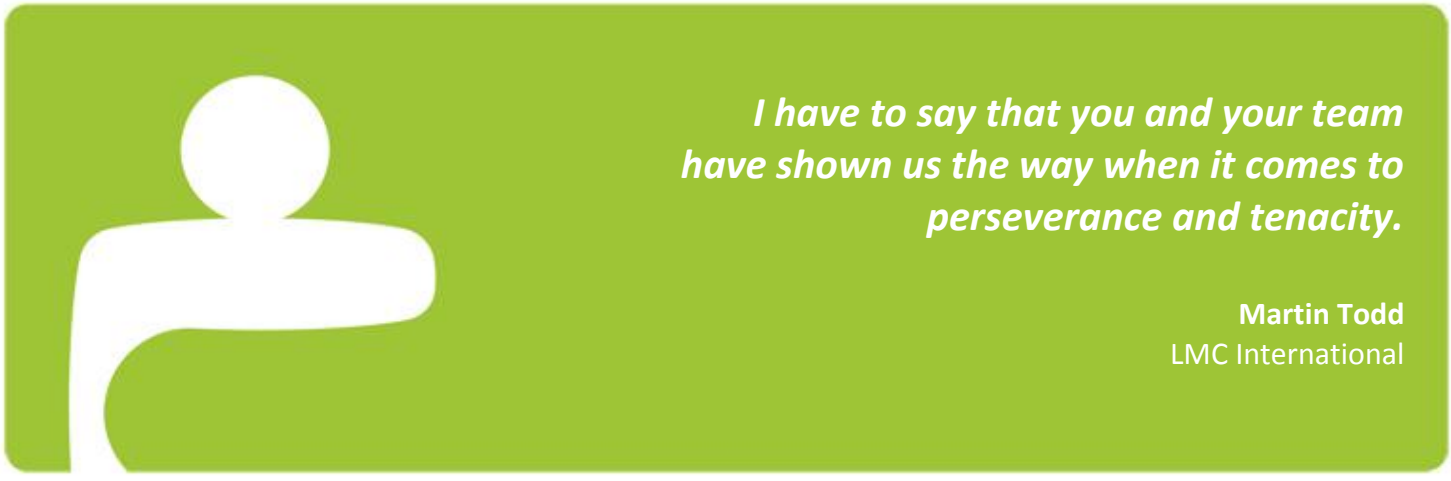
Quorum: the number of people who need to be present at a Board Meeting or General Meeting for it to be legally constituted so that decisions can be made.

Quasi-partnership: a company formed by two or more shareholders in circumstances where they may be regarded as *partners.*

Rectification: the order of a Court requiring a change to the Register of Members.

Special Resolution: a resolution passed by the holders of 75% or more of the voting shares.

Table A: this refers to Table A of the Companies Act 1948 or of the Companies (Tables A to F) Regulations 1985 as amended. This sets out the standard constitution of a private or a public company that can be modified in the company's own Articles of Association. For companies incorporated after 1 October 2009 a new standard set of Articles has been introduced: these are called the Model Articles.



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