Foundational and constitutional issues in company law

Section D: Company law constitutional issues II

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Chapter 3: Minority protection

Introduction

In this chapter we examine the statutory rights of minority shareholders.

- What rights do they have?
- How can they enforce them, and against whom?
- What remedies are appropriate and available to the minority?

Where a shareholder complains that some personal right has been infringed, the company itself does not sue (because, as we will see below, the wrongdoing may be perpetrated by the majority). Rather, it is the minority shareholder who brings the action in order to obtain a remedy for himself, not for the company, as is the case with derivative action.

From the outset you should bear in mind that minority shareholders in owner-managed private companies generally depend upon such businesses for their living. Such shareholders frequently work for the company and participate in its management.

As with partnerships, such companies are founded upon personal relationships of trust and confidence, often involving family members. You should note that the judges frequently refer to them as **quasi-partnerships**.

This should be contrasted with the position of shareholders in large private or public companies. Such shareholders generally have little sentimental attachment to the particular business and view their shares purely as investment vehicles in the expectation of participating in profits (dividends) only.

However, the economic importance of private companies should not be underestimated. Indeed, you may recall that it underpinned the approach of the CLRSG towards reforming company law. Indeed, for 2001–02 over 1,491,500 companies were on the effective register. Of these 99.2 per cent were private companies.

Essential reading

- Dignam and Lowry, Ch. 11: 'Statutory shareholder remedies'.
- Gower and Davies, Ch. 20: 'Unfair prejudice'.
- Sealy and Worthington, Ch. 11: 'Remedies for maladministration of the company' and section on 'Grounds for compulsory winding up – "just and equitable" ground', pp.653–62.

Cases

- *Ebrahimi* v *Westbourne Galleries Ltd* [1973] AC 360.
- *Virdi* v *Abbey Leisure Ltd* [1990] BCC 60.
- *Re Ghyll Beck Driving Range Ltd* [1993] BCLC 1126.
- *Re Elgindata Ltd* [1991] BCLC 959.
- *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354.
- *Re London School of Electronics Ltd* [1986] Ch 211.
- *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14 CA, [1994] BCC 475.
- *O'Neill* v *Phillips* [1999] 1 WLR 1092.
- *Clark* v *Cutland* [2003] EWCA Civ 810.
- *Re Sam Weller & Sons Ltd* [1989] 5 BCC 810.
- *Anderson* v *Hogg* [2002] BCC 923.
- *Re Bird Precision Bellows Ltd* [1984] Ch 419.

Learning outcomes

By the end of this chapter and the relevant readings you should be able to:

- describe the range of statutory remedies available to minority shareholders
- explain the 'just and equitable' winding-up remedy
- state the principal grounds for 'just and equitable' winding-up
- describe the scope of the unfair prejudice remedy
- describe the remedies available under the unfair prejudice provision.

3.1 Winding-up on the just and equitable ground

Under the law as it stood until recently, aggrieved minority shareholders generally found it easier to 'kill off' the company by petitioning for its winding-up under the 'just and equitable' ground. This was because of the procedural obstacles presented by *Foss* v *Harbottle* (see Chapter 2) and the restrictive approach taken towards the predecessor of s.994 CA 2006 and, indeed, towards the unfair prejudice provision itself prior to its amendment by the Companies Act 1989.

It should be noted that although s.994 of the Companies Act 2006 has come to the fore in the armoury of 'oppressed' shareholders, s.122(1)(g) of the Insolvency Act 1986 is not completely redundant.

3.1.1 Section 122

Section 122(1)(g) IA 1986 states: '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.'

This provision derives from partnership law, where the court had equitable jurisdiction to dissolve a partnership where relations had broken down between the partners and there was no other alternative but to dissolve the business.

With regard to companies, the remedy has come to the fore in relation to small private companies termed quasi-partnerships. As commented above, such companies are akin to partnerships because the personal relationships between the directors (who generally fulfil a number of roles in the business, for example as both shareholders and employees) are crucial to the effective operation of the company's business. If confidence breaks down between them, the company is therefore effectively disabled.

As indicated above, because of the range of remedies available under the unfair prejudice provision (discussed below), it has now become the dominant means available to minority shareholders seeking redress. However, it does not expressly provide for winding-up. Therefore s.122(1)(g) IA 1986 is still of relevance, although given the wide discretion which s.996 confers on the court in framing a remedy, technically winding-up is probably available for unfair prejudice petitions.

That said, it was (and still is) common practice to petition for an order under s.122(1)(g) IA 1986 by way of an alternative to s.994 CA 2006. The CPR Practice Direction, Part 49B(1) (replacing Chancery 1/90 (Practice Direction) [1990] 1 All ER 1056) sought to prevent this tactic. It provides that:

> Attention is drawn to the undesirability of asking as a matter of course for a winding up order as an alternative to an order under s.459 of the Companies Act 1985 [now s.994 CA 2006]. The petition should not ask for a winding up order unless that is the relief which the petitioner prefers or it is thought that it may be the only relief to which he is entitled.

The typical elements of s.122(1)(g) petitions

Winding-up on the just and equitable ground was subjected to extensive analysis by the House of Lords in *Ebrahimi* v *Westbourne Galleries Ltd* [1973] AC 360 (Sealy and Worthington, p.659).

The company was incorporated to take over the oriental rug business which N and the petitioner, E, had been running as a partnership for some 10 years.

Initially N and E were equal shareholders and the only directors. However, when N's son joined the company as director and shareholder, E became a minority both within the board and at the general meeting, where he could be outvoted by the combined shareholding of N and his son.

Relations between E on the one hand, and N and his son on the other, broke down. E was voted off the board using the power conferred by s.303 CA 1985.

It was held that even though E had been removed from the board in accordance with the Companies Act and the articles of association, the just and equitable ground conferred on the court the jurisdiction to subject the exercise of legal rights to **equitable considerations**. Since E had agreed to the formation of the company on the basis that the essence of their business relationship would remain the same as in their prior partnership, his exclusion from the company's management was clearly in breach of that understanding. It was therefore just and equitable to wind up the company. Lord Wilberforce listed the typical elements in petitions brought under this ground:

- a business association based on a personal relationship and mutual confidence[1]
- an understanding that all or certain shareholders (excluding 'sleeping' partners) will participate in management
- restriction on the transfer of members' interests preventing the petitioner leaving.

[1] Generally found where a pre-existing partnership has converted into a limited company.

Lord Wilberforce stressed that the court was entitled to superimpose equitable constraints upon the exercise of rights set out in the articles of association or the Act. He went on to say that the words 'just and equitable':

> are a recognition of the fact that a limited company is more than a mere legal entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations *inter se* which are not necessarily submerged in the company structure.

It should be noted that Lord Cross stressed that petitioners under s.122(1)(g) should come to court with clean hands – that is, they should not themselves be guilty of unconscionable conduct. If a petitioner's own misconduct led to the breakdown in relations, relief will be denied.

A petition under s.122(1)(g) of the 1986 Act will be allowed on several grounds, including:

- failure of the company's substratum
- fraud
- deadlock
- justifiable loss of confidence in the company's management
- exclusion from participation in a small private company where there was a relationship based on mutual confidence.

We will look at each of these in turn.

The company's substratum has failed

The petitioner will need to establish that the commercial object for which the company was formed has failed or has been fulfilled. In *Re German Date Coffee Co* (1882) 20 Ch D 169 the company was registered with the object of acquiring a German patent for manufacturing from dates a substitute for coffee. The patent was not granted. The Court of Appeal held that the whole substratum of the company had gone and it ought to be wound up. See also *Virdi* v *Abbey Leisure Ltd* [1990] BCLC 342.

In *Re Perfectair Holdings Ltd* [1990] BCLC 423 it was held that a company should be wound up where its sole remaining purpose was to get in its assets and wind up its affairs. The court stressed that winding-up was the function of a liquidator, not the directors.

Fraud

The s.122(1)(g) remedy enables shareholders to recover their investment where the company was formed by its promoters in order to perpetrate a fraud against them. In *Re Thomas Edward Brinsmead & Sons* [1887] 1 Ch 45 (Sealy and Worthington, p. 653) three men named Brinsmead, who were former employees of John Brinsmead & Sons, an established and reputable firm which manufactured pianos, formed a company called Thomas Brinsmead & Sons to make pianos which were to be passed off as made by

John Brinsmead & Sons. By way of a promotion fraud, the public had subscribed for shares worth thousands of pounds in their company. It was held by the Court of Appeal that it was just and equitable to wind up the company.

Deadlock

Total deadlock is rare, since if there is an equality of votes at a meeting of the directors or members, the chair of the meeting will generally have a casting vote. However, the court will order a company to be wound up where there is practical, although not total, deadlock in its management.

In *Re Yenidje Tobacco Co Ltd* [1916] 2 Ch 426 (Sealy and Worthington, p.658) there were two equal shareholders and directors. Relations between them had broken down to such an extent that they were in continuous argument and would not speak to each other. Drawing on partnership principles, the court ordered the company to be wound up. Lord Cozens-Hardy MR observed:

> [H]aving regard to the fact that the only two directors will not speak to each other, and no business which deserves the name of business in the affairs of the company can be carried on, I think the company should not be allowed to continue. I have treated it as a partnership, and under the Partnership Act of course the application for dissolution would take the form of an action; but this is not a partnership strictly, it is not a case in which it can be dissolved by action. But ought not precisely the same principles to apply to a case like this where in substance it is a partnership in the form of the guise of a private company? It is a private company, and there is no way to put an end to the state of things which now exists except by means of a compulsory order.

Justifiable loss of confidence in the company's management

Winding-up may be ordered where there is a lack of confidence in the competence or probity of its management, provided the company is, in essence, a quasi-partnership.

In *Loch* v *John Blackwood Ltd* [1924] AC 783 (Sealy and Worthington, p.655) the company was a small private company and the shareholders were related. The board was dominated by the majority shareholder, who treated the company as his own. He was attempting to buy out the minority shareholders, who were not directors, at an undervalue. Further, the board failed to hold general meetings or render accounts or declare a dividend.

The Privy Council found that there was a justifiable lack of confidence in the probity of the majority shareholder and ordered the company to be wound up.

Lord Shaw stressed that the lack of confidence must relate to directors in their conduct of the company's affairs.

In *Re RA Noble & Sons (Clothing) Ltd* [1983] BCLC 273 Nourse J took the view that, provided the conduct of the majority was the substantial cause of the breakdown in the relationship between the parties, it was not necessary to demonstrate that the conduct in question was underhand or to inquire into the petitioner's own conduct. Compare *Re a company* [1983] 2 All ER 854.

Exclusion from participation in a small private company where there was a relationship based on mutual confidence

A classic example of this is the case of *Ebrahimi* v *Westbourne Galleries* itself, in which, it will be recalled, Lord Wilberforce said that the typical elements in cases falling under this ground were that:

- the basis of the association was a personal relationship and mutual confidence
- there was an understanding that certain shareholders would participate in management
- the company had a restriction on the transfer of shares.

Activity 3.1

Read *Re a Company (No 004415 of 1996)* [1997] 1 BCLC 479.

Why did the court strike out the winding-up petition?

Feedback: page 39.

Activity 3.2

Read *Virdi* v *Abbey Leisure Ltd* [1990] BCLC 342.

Why was winding-up under s.122(1)(g) IA 1986 considered to be an appropriate remedy?

Feedback: page 39.

3.1.2 Relationship with other remedies

Winding-up is a measure of last resort. Therefore where the petitioner is acting unreasonably in seeking to have the company wound up instead of seeking an alternative remedy, the petition may be struck out: see s.125(2) IA 1986.

Obviously, if the company is solvent and s.994 CA 2006 provides a suitable route for the petitioner to exit the company, the court will generally consider the petitioner to be acting unreasonably in seeking to have the company wound up. See also CPR Practice Direction Part 49B, para. 9(1) above.

If a fair offer is made to buy the petitioner out, he cannot expect more from the court.

In *Re Guidezone Ltd* [2000] 2 BCLC 321 Jonathan Parker J, in examining the inter-relationship between the two remedies, placed particular emphasis on *O'Neill* v *Phillips* [1999] 1 WLR 1092, [1999] 2 BCLC 1 (see below), the only House of Lords decision on s.994, where Lord Hoffmann subjected the unfair prejudice remedy to detailed scrutiny:

> In my judgment, [counsel for the petitioners'] submission is based on a misreading of both *Westbourne Galleries* and *O'Neill v. Phillips*. In the first place, in *Westbourne Galleries* Lord Wilberforce expressly warned against simply treating a company (even a 'quasi-partnership' company) as if it were a partnership; a warning which Lord Hoffmann quoted in *O'Neill v. Phillips*. Secondly, in drawing a

> parallel in *O'Neill v. Phillips* between the jurisdiction to order a winding up on the just and equitable ground and the jurisdiction under section 459 [now s.994 CA 2006], Lord Hoffmann applied the reasoning of Lord Wilberforce in *Westbourne Galleries*. Thirdly, I accept [counsel for the respondents'] submission that it is difficult to believe that Lord Hoffmann would have placed the limits on the section 459 jurisdiction which he did, had he thought that by so doing he was in effect transferring business from the section 459 jurisdiction to the winding-up jurisdiction. On the contrary, it is plainly implicit in Lord Hoffmann's reasoning, as I read his speech, that the winding-up jurisdiction is, at the very least, no wider than the section 459 jurisdiction: a proposition which is consistent with a winding-up order being, as it were, the death sentence on a company (an analogy drawn by Mummery LJ in *In re a Company, ex parte Estate Acquisition and Development Ltd* [1991] BCLC 154, 161), and with the statutory recognition in section 125(2) of the Insolvency Act (see above) that a winding-up order is an order of last resort. Fourthly, it would in my judgment be extremely unfortunate, and inconsistent with the approach and the reasoning of Lord Hoffmann in *O'Neill v. Phillips*, if, given the two parallel jurisdictions, conduct which is not 'unfair' for the purposes of section 459 should nevertheless be capable of founding a case for a winding-up order on the 'just and equitable' ground. As to Nourse J's decision in *Noble*, in so far as that decision is authority for the proposition that conduct which is not unfair for the purposes of section 459 can nevertheless found a case for a winding-up on the just and equitable ground it is in my judgment inconsistent with *O'Neill v. Phillips*.

Reminder of learning outcomes

By this stage you should be able to:

- explain the 'just and equitable' winding-up remedy
- state the principal grounds for 'just and equitable' winding-up.

3.2 Unfair prejudice – s.994 CA 2006

Section 994 provides that:

> A member of a company may apply to the court by petition for an order…on the ground
>
> (a) that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself), or
>
> (b) that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

Although, as will be seen, s.996 confers on the court a broad discretion in terms of the remedies available, petitioners generally seek an order requiring the respondents, commonly the majority shareholders, to purchase their shares (s.996(2)(e) CA 2006).

3.2.1 The elements of the remedy

The petitioner must establish that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to his interests as a member.

'The company's affairs'

In *Re Legal Costs Negotiators Ltd* [1999] 2 BCLC 171 the company had been incorporated by four individuals who were equal shareholders. The shareholders were also its directors and employees.

Relations broke down with the fourth individual. He was dismissed as an employee and resigned from the board just before it was resolved to remove him. However, he remained as a shareholder and refused to sell his shares to the other three.

The majority brought an action under s.994 seeking an order that he should transfer his shares to them. The Court of Appeal rejected the petition on the basis that, as majority shareholders, they could prevent any prejudice being inflicted by him on the company. Simply remaining as a shareholder was not conduct relating to the company's affairs. The Court stressed that the conduct complained of must:

- relate to the affairs of the company
- be acts done by the company or those authorised to act as its organs
- not be the conduct of an individual shareholder acting in his private capacity.

Similarly, relief will be refused where the petition relates to the respondent's failure to honour a shareholders' agreement to transfer shares. See:

- *Re Unisoft Group Ltd (No. 3)* [1994] 1 BCLC 609.
- *Re Leeds United Holdings plc* [1996] 2 BCLC 545.

However, a special resolution to amend the articles to exclude pre-emption rights in a company could be unfairly prejudicial conduct. See *Re Smiths of Smithfield Ltd* [2003] BCC 769.

In *Re City Branch Group Limited* [2004] EWCA Civ 815 (Sealy and Worthington, p.555) the Court of Appeal held that an order under s.994 could be made against a holding company where the affairs of a wholly-owned subsidiary have been conducted in an unfairly prejudicial manner and the directors of the holding company are also the directors of the subsidiary (see also *Nicholas* v *Soundcraft Electronics Ltd* [2003] BCLC 360.)

'Interests as a member'

Although the petitioner must be a shareholder in order to bring the action, the requirement that his interests *qua* member must have been unfairly prejudiced has not been restrictively construed.[2]

[2] Compare the old oppression remedy under s.210 CA 1948, where the courts adopted a strict approach to this requirement.

For example, exclusion from the management of the company, which technically speaking is conduct affecting the petitioner *qua* director, will nevertheless suffice. See *O'Neill* v *Phillips* [1999] 1 WLR 1092, HL (Sealy and Worthington, p.572).

However, in *Re J.E. Cade & Son Ltd* [1992] BCLC 213 the petition was struck out where the court found that the petitioner's true motive in bringing the action was not to obtain relief *qua* member of the company operating a farm, but to obtain possession of the agricultural land in his capacity as landlord.

A further point to note is that the provision uses the term ‘interests’. This is designed to be expansive in effect and so effectively avoids the straitjacket which terminology such as ‘rights’ would impose on the scope of the provision. See:

- *Re Sam Weller & Sons Ltd* [1989] 5 BCC 810.
- *Re a Company (No. 00477 of 1986)* [1986] BCLC 376.

In *Ebrahimi* v *Westbourne Galleries* Lord Wilberforce recognised that in most companies, irrespective of size, a member’s rights under the articles of association and the Companies Act could be viewed as an exhaustive statement of his interests as a shareholder. However, as we saw above, he went on to list three situations in which equitable considerations could be ‘superimposed’:

- where there is a personal relationship between shareholders which involves mutual confidence
- where there is an agreement that some or all should participate in the management
- where there are restrictions on the transfer of shares which would prevent a member from realising his investment.

This element of Lord Wilberforce’s speech received extensive consideration by the House of Lords in *O’Neil* v *Phillips* [1999] 1 WLR 1092. Here it was concluded that, for the purposes of s.994, the court can apply equitable restraints to contractual rights.

Re Ghyll Beck Driving Range Ltd [1993] BCLC 1126 is a paradigm s.994 case. A father and son, with two other people, incorporated a company to operate a golf range. They were each equal shareholders and directors. Within six months of the company’s existence the relationship between the parties had become acrimonious, due mainly to disagreements over business strategy which left the petitioner feeling ‘isolated’.

Following a fight between the father and the petitioner, the business was managed without consulting him. It was held that the petitioner had been unfairly excluded from the management of the company, since from the start it had been anticipated that all four would participate in managing the business. The court therefore ordered the majority to purchase the petitioner’s shares on the basis that the affairs of the company had been conducted in a manner unfairly prejudicial to his interests.

However, it should be noted that s.994 should not be taken to mean that the judges may administer arbitrary justice. Indeed, Lord Wilberforce had recognised in *Ebrahimi* that the starting point for the court was always to look to the agreement between the parties, for example as contained in the articles. In *Re a Company (No. 004377 of 1986)* [1987] BCLC 94, the majority, including the petitioner, voted for a special resolution to amend the company’s articles so as to provide that a member, on ceasing to be an employee or director of the company, would be required to transfer his or her shares to the company.

To remedy a situation of management deadlock, the petitioner was dismissed as director and offered £900 per share.

When he declined this offer, the company's auditors valued his shares in accordance with the pre-emption clauses. He petitioned the court under s.994 to restrain the compulsory acquisition of his shares, arguing that he had a legitimate expectation that he would continue to participate in the management of the company. Hoffmann J held that there could be no expectation on the part of the petitioner that, should relations break down, the article would not be followed. The judge stressed that s.994 could not be used by the petitioner to relieve him from the bargain he had made.

The limits of so-called legitimate expectations are most apparent in large private or public companies which have comprehensively drafted articles of association. In such companies there is little scope for a minority shareholder to expect to participate in management. In this respect Vinelott J observed in *Re Blue Arrow plc* [1987] BCLC 585:

> No doubt there are cases where a legitimate expectation may be inferred from arrangements outside the ambit of the formal constitution of the company, but it must be borne in mind that this is a public company, a listed company, and a large one, and that the constitution was adopted at the time when the company was first floated on the Unlisted Securities Market. 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.

See also:

- *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8.
- *Re Saul D. Harrison & Sons plc* [1995] 1 BCLC 14, CA, [1994] BCC 475.

Summary

- The interests of members include rights derived from:
  - the articles of association,
  - statute,
  - a shareholders' agreement, or
  - some general equitable duty owed by the directors to the company.
- A member will also have an interest in maintaining the value of his shares: *Re Bovey Hotel Ventures Ltd* 31 July 1981, unreported, cited by Nourse J in *Re R. A. Noble & Sons (Clothing) Ltd* [1983] BCLC 273.
- Further, as *seen* in *Re Ghyll Beck Driving Range Ltd*, a member's 'interests' may also encompass the expectation that he will continue to participate in management. See also:
  - *Re a Company (No. 003160 of 1986)* [1986] BCLC 391.
  - *Re a Company* (*No. 004475 of 1982)* [1983] Ch 178.

'Unfair prejudice' – relevant case-law

The petitioner must establish that the conduct in question is 'both prejudicial (in the sense of causing prejudice or harm) to the relevant interests and also unfairly so': *Re a Company, ex p Schwarcz (No. 2)* [1989] BCLC 427, *per* Peter Gibson J.

In *Re Ringtower Holdings plc* (1988) 5 BCC 82 Peter Gibson J stated that 'the test is unfair prejudice, not of unlawfulness, and conduct may be lawful but unfairly prejudicial.'

Thus, resolving to remove a director is perfectly legal (see s.168 CA 2006; an ordinary resolution is sufficient). However, it may amount to unfairly prejudicial conduct. The notion of unfairness was considered by the Jenkins Committee (Cmnd. 1749, 1962) to be 'a visible departure from the standards of fair dealing and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely' (para. 204, adopting the view expressed by Lord Cooper in *Elder* v *Elder & Watson Ltd* [1952] SC 49).

Although there is no requirement that the petitioner should come to court with 'clean hands', his conduct will be relevant in assessing whether the conduct of the company, though prejudicial, is unfair.

The courts take a dim view of petitioners who delay in presenting their petition, but are mindful that to strike out a petition on this ground may be unduly harsh. See *Hateley* v *Morris* [2004] 1 BCLC 582, Mann J.

In *Re Saul D. Harrison & Sons plc* [1995] 1 BCLC 14 CA, [1994] BCC 475 (Sealy and Worthington, p.571), Hoffmann LJ laid down guidelines for determining unfairness. He stressed that:

- Fairness for the purposes of s.994 must be viewed in the context of a commercial relationship.
- The articles of association are the contractual terms that govern the relationships of the shareholders with the company and each other.

The first question to ask, therefore, is whether the conduct of which the shareholder complains was in accordance with the articles of association.

In *O'Neil* v *Phillips* [1999] WLR 1092 (Sealy and Worthington, p.572), the only House of Lords decision on s.994 so far, Lord Hoffmann held that fairness was to be determined by reference to 'traditional' or 'general' equitable principles. He stressed that company law had developed from the law of partnership – which was treated by equity as a contract of good faith.

The facts of *O'Neil* v *Phillips* were that the company, Pectel Ltd, provided asbestos stripping services to the construction industry.

In 1983 the issued share capital of the company, 100 £1.00 shares, was owned entirely by Mr Philips (P). Mr O'Neill (O) was employed by the company in 1983 as a manual worker. P was favourably impressed by O and he received rapid promotion.

In early 1985 O received 25 per cent of the company's shares and he was made a director. In May 1985 O was informed by P that he, O, would eventually take over the running of the company's business and at that time would receive 50 per cent of the profits. In December 1985 P retired from the board and O became sole director and effectively the company's managing director.

The business enjoyed good profitability for a while, but its fortunes declined during the recession of the late 1980s. In August 1991, disillusioned with O's management of the business, P used his majority voting rights to appoint himself managing director and took over the management of the company.

O was informed that he would no longer receive 50 per cent of the profits. His entitlement would be limited to his salary and dividends on his 25 per cent shareholding. Early discussions about further share incentives when certain targets were met were aborted. O thereupon issued a petition alleging unfairly prejudicial conduct on the part of P.

The House of Lords found that P's conduct would have been unfair if he had used his majority voting power to exclude O from the business. He had not done this, but had simply revised the terms of O's remuneration. P's refusal to allot additional shares as part of the proposed incentive scheme was not unfair as the negotiations were not completed and no contractual undertaking had been entered into by the parties.

Nor was P's decision to revise O's profit-sharing arrangement unfair conduct. O's entitlement to 50 per cent of the company's profits was never formalised. It was, in any case, conditional upon O running the business. That condition was no longer fulfilled as P had to assume control over the running of the business. Although O argued that he had lost trust in P, that alone could did not form the basis for a petition under the unfairly prejudicial conduct provision. To hold otherwise would be to confer a unilateral right to withdraw his capital on a minority shareholder. O's petition therefore failed. He did not prove that P's conduct was both unfair and prejudicial.

Further examples of conduct that **does** amount to unfair prejudice include:

- Exclusion from management. This is a typical s.994 complaint. See:
  - *Re XYZ Ltd (No. 004377of 1986)* [1987] 1 WLR 102.
  - *Re Ghyll Beck Driving Range Ltd*.
  - *Brownlow* v *GH Marshall Ltd* [2001] BCC 152.
- Mismanagement (breach of the directors' duties of care and skill). See:
  - *Re Elgindata Ltd* [1991] BCLC 959 (Sealy and Worthington, p.569).
  - *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354 (Sealy and Worthington, p.570).
- Breach of fiduciary duties. The case law shows that s.994 may be used to obtain a personal remedy despite the rule in *Foss* v *Harbottle.* See:
  - *Re London School of Electronics Ltd* [1986] Ch 211.
  - *Re Little Olympian Each-Ways Ltd (No. 3)* [1995] I BCLC 636.
  - *Re Baumler (UK) Ltd* [2004] EWHC 7673 (Ch).
- Excessive remuneration taken by the directors and the failure to pay dividends. See:
  - *Re Sam Weller & Sons Ltd* [1990] Ch 682.
  - *Re a Company (No. 004415 of 1996)* [1997] 1 BCLC 479.
  - *Re Cumana Ltd* [1986] BCLC 430.
  - *Anderson* v *Hogg* [2002] BCC 923.
  - *Grace* v *Biagioli* [2006] 2 BCLC 70.

Activity 3.3

Read *O'Neill* v *Phillips* [1999] WLR 1092 (Sealy and Worthington, p.572). Write a summary, not exceeding 500 words, of Lord Hoffmann's speech.

No feedback available.

Summary

- In *Re Saul D. Harrison* and *O'Neill* v *Phillips* Lord Hoffmann took the opportunity to inject content into the concept of fairness.
- He reaffirmed the sanctity of the s.33 contract.
- The House of Lords stressed that the remedy did not confer on the petitioner a unilateral right to withdraw his capital.
- In order to succeed under s.994, a petitioner will need to prove either a breach of contract (including the s.33 contract) or breach of a fundamental understanding which, although lacking contractual force, makes it inequitable for the majority to go back on the 'promise'.

Activity 3.4

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

- What was the principal allegation of the petitioners?
- How did Arden J approach the issue of assessing whether the conduct was unfairly prejudicial?
- What remedy was sought?

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3.2.2 Remedies – s.461 CA 1985

Section 996(1) of the Companies Act 2006 provides that the court 'may make such order as it thinks fit for giving relief in respect of the matters complained of'. Section 996(2) goes on to add:

> Without prejudice to the generality of subsection (1), the court's order may—
>
> (a) regulate the conduct of the company's affairs in the future;
>
> (b) require the company –
>
> (i) to refrain from doing or continuing an act complained of, or
>
> (ii) to do an act which the petitioner has complained it has omitted to do,
>
> (c) authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct;
>
> (d) require the company not to make any, or specified, alterations in its articles without the leave of the court;
>
> (e) provide for the purchase of the shares of any members of the company by other members or by the company itself and, in the

> case of a purchase by the company itself, the reduction of the company's capital accordingly.

You should note the width of the court's powers under s.996(1); compare the winding-up remedy, discussed above. Section 996(1) gives the court the power to fashion a remedy to the wrong done. See *Re A Company ex p Estate Acquisition & Development Ltd* [1991] BCLC 154. Indeed, in *Re Brightview Ltd* [2004] BCC 542 the judge could see no reason why an award of damages could not be ordered.

Section 996(2) specifies certain remedies available. The most common remedy sought is that under s.996(2)(e), purchase of shares. See the approach taken by the court in *Grace* v *Biagioli*.

Valuation of shares

Valuing shares in quoted companies is a fairly straightforward exercise because reference can be made to their market price. For unquoted companies – and the vast majority of s.994 petitions fall within this category – the valuation exercise is a far more difficult undertaking. The court has a wide discretion to do what is fair and equitable in all the circumstances of the case. Under the Civil Procedure Rules the court is expected to adopt a vigorous approach towards share valuation: *North Holdings Ltd* v *Southern Tropics Ltd* [1999] BCC 746.

In *Re Bird Precision Bellows Ltd* [1984] Ch 419, affirmed by the Court of Appeal [1985] 3 All ER 523 (Sealy and Worthington, p.576), the court reviewed the approach to be adopted towards valuing shares. It was stressed that the overriding objective was to achieve a **fair price** and that normally no discount would be applied given that the petitioner is an unwilling vendor of what is, in effect, a partnership share (i.e. the shares will be valued on a pro rata basis according to the value of all the issued share capital).

If, however, the shareholding is acquired by way of an investment, a discount may in the circumstances be fair so as to reflect the fact that the petitioner has little control over the company's management. Thus in *Elliott* v *Planet Organic Ltd* [2000] 1 BCLC 366 the court took the view that in valuing preference shares for the purposes of a purchase order, account should be taken of the fact that they were investors who took a passive role in the company's affairs. They were therefore valued at a discount. See also the speech of Lord Hoffmann in *O'Neill* v *Phillips*, discussed above.

As to the date to be taken for valuing shares, generally this will be the date of the purchase order given that this is the time when the conduct which is the basis of the complaint is brought to an end.

However, as noted above, the anxiety of the court is directed towards achieving a fair price, and so an earlier date may be taken.

The court may, therefore, take the date of the petition as the valuation date on the basis that this is the moment in time when the petitioner opted to treat the conduct of the majority as bringing to an end the basis upon which he became a member of the company. Some guidelines in this regard were laid down by Robert Walker LJ in *Profinance Trust SA* v *Gladstone* [2002] 1 BCLC 141:

> The date of valuation
>
> The authorities show that there are two main considerations which the court has to bear in mind in deciding what valuation date is fair on the facts of the particular case. One is that the shares should be valued at a date as close as possible to the actual sale so as to reflect the value of what the shareholder is selling. This is clearly expressed in the judgment of Nourse J in *Re London School of Electronics Ltd* [1985] BCLC 273 at 281, [1986] Ch 211 at 224:
>
>> 'If there were to be such a thing as a general rule, I myself would think that the date of the order or the actual valuation would be more appropriate than the date of the presentation of the petition or the unfair prejudice. Prima facie an interest in a going concern ought to be valued at the date on which it is ordered to be purchased.'
>
> In that case City Tutorial College Ltd, the majority shareholder in London School of Electronics Ltd, had through its directors diverted the latter company's BSc students to itself for the 1983-84 academic year.
>
> Nourse J directed a valuation at the date of the petition (which was presented during that academic year), with appropriate adjustments. He declined to take a later date, on the grounds…that the directors of City Tutorial College Ltd, have now been able to acquire a greater academic standing for the course in this country. I find that has been entirely due to their own efforts and owes nothing to the petitioner and, moreover, that it is unlikely that it would have been achieved if the petitioner had remained with the company.

The rival consideration was stated by Vinelott J in *Re a Company (No. 002612 of 1984)* (1986) 2 BCC 99, 453 at 99,492–99,493. After referring to *Re London School of Electronics*, he said:

> I would respectfully agree with Nourse J that there is no rigid rule applicable to all circumstances, though I would at least incline to the view that the date of the petition is the correct starting point, the valuation of course being adjusted to take account of unfair conduct which has depreciated the value of the shares…and that a departure from this date must be justified on the ground of some special circumstance. The date of the petition is the date on which the petitioner elects to treat the unfair conduct of the majority as in effect destroying the basis on which he agreed to continue to be a shareholder, and to look to his shares for his proper reward from participation in a joint undertaking.

The clearest reason for selecting an early valuation date is that there has been a major change (whether for the better or for the worse) in a company's capital structure and business. An early example is *Re OC (Transport) Services Ltd* [1984] BCLC 251, in which the majority shareholder had used his control to increase the company's issued capital by 750 per cent and to make it a partly-owned subsidiary of another company of his. Mervyn Davies J said: 'on a [section 994] application fairness sometimes requires a valuation to relate back to a date earlier than the date of the petition. This is such a case.'

See also *Richardson* v *Blackmore* [2006] BCC 276.

3.3 Costs

As seen above, it is possible to petition under s.994 for breach of fiduciary duties. This is technically a wrong to the company. See:

- *Re London School of Electronics Ltd* [1986] Ch 211.
- *Re Little Olympian Each-Ways Ltd (No. 3)* [1995] I BCLC 636.

You will recall from Chapter 2 that in *Wallersteiner* v *Moir (No. 2)* Buckley LJ stated that the shareholder who initiates a derivative action may be entitled to be indemnified by the company at the end of the trial for his costs provided he acted reasonably in bringing the action. CPR 19.9(7) covers costs. It states that the court may order the company to indemnify the claimant against any liability in respect of costs incurred in the claim. An application under CPR 19.9(7) may be made at the time of applying for permission to continue the claim.

However, since s.994 is a personal remedy, the courts have long resisted claims by petitioners that companies should pay their costs. This has been the case even where the substance of the allegation is that directors had used their powers for an improper purpose by issuing shares to alter the constitutional make-up of the company (i.e. in breach of their fiduciary duties, see *Re a Company* [1987] BCLC 82).

In *Clark* v *Cutland* [2003] 2 BCLC 393 the issue of funding a s.994 petition came to the fore where the conduct complained of related to a director taking around £145,000, from the company without authority and paying it into his own pension fund. This clearly constituted a breach of fiduciary duty and the petitioner brought a derivative action on behalf of the company which was consolidated with a petition under s.994.

Arden LJ took the provisional view that although a remedy was claimed under s.996 CA 2006 this was essentially for the benefit of the company so that, therefore, the petitioner could seek an order against the company for payment to him of costs, unless of course costs were recovered from the respondent, Mr Cutland.

It therefore seems that if the company benefits from the remedy sought it may be ordered to pay the petitioner's costs. The point was also made that when considering the range of remedies available under s.996, the court can have recourse to those available on a derivative action.

Activity 3.5

(a) In what circumstances will a court wind up a company on the 'just and equitable' ground under s.122(1)(g) Insolvency Act 1986?

(b) 'The problem that s.994 poses for the courts is that unless it is restrictively construed it has the potential to become a means of oppression by the minority over the majority.' Discuss.

Feedback: page 40

Useful further reading

- Lowry, J.P 'Mapping the boundaries of unfair prejudice.' in de Lacey (ed.), *The Reform of UK Company Law.* (London: Cavendish Press, 2002).
- Lowry, J.P. 'Reconstructing shareholder remedies: The Law Commission's Consultation Paper No. 142' [1997] *Co Law* 247. (Note: you should read this volume of the *Company Lawyer* because it is devoted to reviewing the Law Commission's reform proposals.)
- Lowry, J.P 'Stretching the ambit of section 459 of the Companies Act 1985: The elasticity of unfair prejudice' (1995) *LMCLQ* 337.
- Prentice, D.D. 'The theory of the firm: minority shareholder oppression: sections 459–461 of the Companies Act 1985' [1988] *OJLS* 55.
- Reisberg, A. 'Indemnity costs orders under s 459 petitions' [2004] *Comp Law* 116.
- Reisberg, A. 'Shareholders' remedies: in search of consistency of principle in English law' [2005] *European Business Law Review* 1063.
- Riley, C.A. 'Contracting out of company law: section 459 of the Companies Act 1985 and the role of the courts' [1992] *MLR* 782.

Reminder of learning outcomes

By this stage you should be able to:

- describe the range of statutory remedies available to minority shareholders
- explain the 'just and equitable' winding-up remedy
- state the principal grounds for 'just and equitable' winding-up
- describe the scope of the unfair prejudice remedy
- describe the remedies available under the unfair prejudice provision.

Feedback to activities

Activity 3.1 *The petitioners argued that the majority shareholders, who were also the directors, had run three companies for their own benefit by claiming excessive remuneration while paying low dividends to non-director shareholders. On the facts, the court considered that:*

- *The petitioners had an arguable claim for relief under s.454 (the precursor to s.994 CA 2006).*
- *An order requiring the respondents to purchase the petitioners' shares at a fair price to be determined by the court would be more appropriate than destroying the company by ordering its winding-up.*

Activity 3.2 *The Court of Appeal held that the petitioner was not acting unreasonably in refusing to accept a valuation of his shares by the company's auditor, as provided in the articles, given that his shares might be discounted in circumstances where a discount was inappropriate. Balcombe LJ took the view that it would be just and equitable to ignore the articles of association and allow the petition to proceed.*

The converse of the decision in Virdi *is that if an offer to purchase a petitioner's shares is fair, the petitioner will be acting unreasonably in seeking a winding-up order rather than seeking relief under s.994 CA 2006.*

Activity 3.4 *The evidence of the events giving rise to the claim spans a period of some 40 years. The petitions were brought against two associated companies, Macro (Ipswich) Ltd and Earliba Finance Co Ltd. The petitioners alleged that the conduct of the companies' sole director, Mr Thompson (T), amounted to mismanagement which unfairly prejudiced their interests as members. At the time of the petition T was 83 years of age. He was described as a 'patriarchal figure', and engaged in serious disagreements with the petitioners.*

It is noteworthy that of the three petitioners, one was T's son, the other two were his nephews. Central to the mismanagement allegation was the complaint that T's hands-off style of management left the companies vulnerable to the dishonesty and neglect of his employees at Thompsons, an estate agency business which managed a substantial number of rental properties owned by the company. The petitioners alleged that Thompsons' employees received secret commissions from builders, the cost of which was passed on to the companies, and that they took 'key' money from new tenants. It was successfully argued that the substantial financial losses suffered were due to T's mismanagement, which unfairly prejudiced the petitioners.

Arden J stated that the question whether any conduct was 'unfairly prejudicial' to the interests of the members has to be judged on an objective basis. It has to be determined, on an objective basis:

1. *whether the action of which complaint is made is prejudicial to members' interests*
2. *whether it is unfairly so.*

In granting relief, the court took the view that, rather than appoint the petitioners to the board, which they had contended had been their expectation, T would be ordered to purchase his son's shares in Macro and Earliba.

Activity 3.5 *(a) The key to answering this question lies in the facts of* Ebrahimi *and the speech delivered by Lord Wilberforce in that case. The petitioner must prove some special underlying obligation of his fellow shareholders in good faith that, so long as the business relationship continues, he shall be entitled to participate in management. If such an obligation is broken, the company ought to be wound up.*

Other examples of grounds that will support a petition under s.122(1)(g) include:

- *where the substratum of the company has disappeared:* Re German Date Coffee Co
- *fraud:* Re Thomas Edward Brinsmead & Sons
- *deadlock:* Re Yenidje Tobacco Co Ltd
- *loss of confidence in the company's management:* Loch *v* John Blackwood Ltd.

(b) It is apparent from Re Saul D. Harrison *and* O'Neill *v* Phillips *that Lord Hoffmann took the opportunity to examine the underlying nature of the remedy and inject content into the concept of fairness.*

He did this by subjecting the speech of Lord Wilberforce in Ebrahimi *to considerable scrutiny for the purpose of reaffirming the sanctity of the s.33 contract. The House of Lords stressed that the remedy did not confer on the petitioner a unilateral right to withdraw his capital.*

In order to succeed under s.994 a petitioner will need to prove either a breach of contract (including the s.33 contract) or breach of a fundamental understanding which, although lacking contractual force, makes it inequitable for the majority to renege on it.