SMES, DIRECTORS & SHAREHOLDERS

# Minority shareholders – a practical guide to their rights

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# INTRODUCTION

Majority shareholders often believe that they are entitled to control "their" company as they think fit. This belief commonly leads to tensions as minority shareholders complain that key company decisions are being made without their input. Further, there is often a perception that majority shareholders have abused their majority control to manage a company in a way which benefits them at the expense of the minority or that the majority are acting in a way which is incompetent. Disputes about such matters regularly come before the courts in a variety of different types of claim. This guidance note summarises the main ways in which aggrieved shareholders can take action.

## 1 What should shareholders do if they believe that they have been treated unfairly?

The first step that should be taken by any aggrieved shareholder is to collate all shareholder agreements and other documents (such as emails or meeting notes) which record what the shareholders may have agreed or discussed about how the company should be run. It is important to preserve all potentially relevant documentation, including electronic records. Those documents, together with the company's formal memorandum and articles of association are likely to contain significant provisions about how the company should be run and/or about dispute resolution. Usually it then makes sense to prepare a chronology of key events so that important details are not overlooked when legal advice is being obtained about how to resolve the dispute.

## 2 What types of claim can an aggrieved minority shareholder bring?

An aggrieved minority shareholder may be able to bring various different types of claim including:

1. **A claim for breach of contract;**
2. **A claim for the winding up of the company on "just and equitable" grounds;**
3. **An unfair prejudice petition;**
4. **A derivative claim on behalf of the company.**

## 3 Contractual claims

Often, when companies are established, the founding shareholders enter into professionally drafted shareholders' agreements. Less frequently, such agreements are entered into at a later stage, such as when a new shareholder acquires shares or a significant investment is made. Shareholders' agreements are subject to ordinary contractual principles so, subject to any subsequent variation or waiver, their terms are usually enforceable. Breaching a shareholders' agreement can give rise to awards of damages or to injunctive relief, which will require an application made to court seeking an order to compensate an aggrieved shareholder or to prevent wrongdoing.

However, it is important to recognise that contractual claims can arise without any formal written agreement. The existence of an informal agreement, such as one arising out of a conversation may be hard to prove but, if proven, can be enforced just like any other contract.

## 4 Winding up on "just and equitable" grounds

Under s.122(1)(g) of the Insolvency Act 1986, the court has the power to wind up a company if it is considered "just and equitable" to do so. This power has been exercised in cases where a company is set up as a "quasi partnership" to carry out a particular function but this function can no longer be achieved; alternatively, when a company is in "deadlock" (i.e. a majority over 50% cannot be reached) or the relationship between the parties has broken down completely. This remedy is only appropriate in rare cases because, if the petition is granted, the company will be wound up and eventually, cease to exist with all shareholders suffering as a result. Accordingly, it is more usual for shareholders and the courts to try to find an alternative way to right any wrongs while still preserving the company.

## 5 Unfair prejudice

Under s.994 of the Companies Act 2006, a shareholder can petition the court to allege that a company's affairs have been conducted in a manner which is unfairly prejudicial to the interests of some or all shareholders generally.

Unfair prejudice often involves a majority shareholder breaching the parties' "legitimate expectations" by, for example, taking excessive remuneration as a director or wrongly removing the minority shareholder (or his nominee) from the board of directors. Sometimes the conduct complained of amounts to wrongdoing against the company, such as diverting business opportunities or acquiring company assets at an undervalue.

If unfair prejudice is proven then the court has a wide discretion as to the appropriate remedy. Most commonly, it will order a buy out of the minority shareholder's shares by the majority at a fair price. That price may be based on a hypothetical assumption that any wrong done to the company had not occurred or had otherwise been remedied. Expert valuation evidence is frequently required in these types of disputes. It is unsurprising that there are often lengthy disputes about how the price should be determined.

## 6 Derivative claims

Where a wrong is done to a company (whether or not a shareholder has also suffered) then the proper claimant is the company itself and a shareholder cannot bring his own claim to recover any consequential reduction in the value of his/her shareholding. This is known as the reflective loss principle or the rule in Foss v Harbottle.

Where a wrongdoer is in control of a company then it is unrealistic to expect the wrongdoer to allow the company to pursue any remedy that it may have. The law therefore allows a minority shareholder to seek and obtain permission from the court to bring a claim on behalf of the company. This procedure is known as a derivative claim. The relevant legislation is to be found in sections 262-263 of the Companies Act 2006.

Derivative claims can only be brought where there has been wrongdoing by directors. Such wrongdoing might, but need not, concern a director's fiduciary and statutory duties to act in good faith in the best interests of the company as a whole. Derivative claims can also be brought where a director has been negligent.

The derivative claim procedure is not intended as a way for disgruntled shareholders to second guess commercial decisions taken by directors but to prevent serious wrongdoing to the company. The courts seek to filter out and prevent any trivial claims. Amongst the various factors that a court considers when deciding whether or not to allow a derivative claim to proceed are the views of any actual or hypothetical independent shareholders and directors (i.e. consideration of whether is it genuinely in the company's best interests to pursue the action sought).

In some cases, permission to bring a derivative claim has been obtained as part of the relief granted following a successful unfair prejudice petition.

## CONCLUSION

Disputes concerning the rights of minority shareholders are a specialist area of the law. There are different court procedures to be followed for the different types of claim. Any shareholder considering bringing a claim of this nature and / or any shareholder who may be facing such a claim should seek specialist advice in order to understand the appropriate remedy for any prejudice that has been suffered and whether an early settlement is appropriate in all of the circumstances.

At FWJ we have the expertise to assist minority shareholders understand and enforce their entitlements within their business.