SMES, DIRECTORS & SHAREHOLDERS

How to protect minority shareholder interests

8 frequently asked questions

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INTRODUCTION

Limited liability companies with shareholders are conventionally set up solely for the purpose of running a successful business, generating a profit and at all times acting in the interests of shareholders. Shareholders own the company but do not generally have any say in how it is run on a day to day basis, other than in respect of structural issues (often referred to as corporate governance) pertaining to who runs it and the business objectives and strategy.

The company's business is managed by directors who have the authority to bind the company to various transactions and otherwise deal with all operations, sales, financial matters and other parts of the business. Whilst shareholders have the power to alter the company's structure, in which the directors operate, it is the directors that ultimately make all the day to day decisions.

However, it is often the case, especially within small to medium-sized companies that the shareholders and the directors are the same or similar groups of individuals who incorporated the company with expectations of what each other would do and receive from the company. As time passes, it is very likely that the company's business and their respective shareholder/director relationships will develop but sometimes this development is not necessarily positive. For example, one group may feel vulnerable to decisions by another group (or individual) who may seek to control the company solely by reference to their personal interests.

In this article we attempt to deal with the interests of any shareholders who hold a minority share (i.e. 50% or less) in a company and what could be done to protect their interests in this respect.

1 What control do shareholders have over company decisions?

Generally within limited liability companies there are two documents which determine the structure of how directors can operate and what shareholders rights are.

The first, which is a standard document existing in all companies, is the articles of association ("the articles"). This document provides a framework within which the directors can act, subject to statute, by for example delegating powers to grant security over property, allowing the directors to bind the company into specific transactions and determining how decisions of directors are made.

It can also affect shareholder interests – such as who is entitled to receive an offer for sale of shares should one shareholder decide to exit (often referred to as "pre-emption rights").

Another document, which is not often used in a company but which is incredibly useful, is a shareholders agreement. This is a specific agreement drawn up between shareholders at the outset of a business (or perhaps even later on) where they agree what each other will do as directors in the company and what their expectations are going forward.

This document can provide a remedy where cases of dispute arise. However, it is not a document publicly available at Companies House and will only bind the shareholders originally party to it. If a new shareholder comes into the company then s/he may not be bound by that shareholders agreement (subject to the provisions of the shareholders agreement) and therefore, there may be no such protection for any remaining original shareholders.

2 How do shareholders make decisions?

Most decisions in the company are made by directors but some decisions cannot be made by directors. One example is the ability to remove of a director from office; another maybe a substantial property transaction which involves a connected party, for example selling the main trading premises.

In such circumstances the shareholders are required to vote on any such proposals. Voting by shareholders may occur in writing (dependent on when the company was incorporated under new legislation) or may be by a formal meeting of shareholders (often referred to as a general meeting). All shareholders must receive notice of the general meeting and in certain circumstances, (such as the removal of a director), a special notice may be required (28 days in advance of the meeting).

If these strict requirements are not adhered to then any resolution passed by shareholders may not be valid.

Resolutions are generally passed in one of two categories, ordinary resolutions (requiring 50% plus of shareholder votes) or special resolutions (requiring above 75% of shareholders to agree such a proposed resolution). Most decisions are passed by ordinary resolution, which requires in excess of a 50% vote by shareholders to approve it.

3 Where do problems most commonly arise?

It is a fact of life that two (or more) people often go into business together with shared objectives and a shared mutual understanding of each other's role in the company but at the same time, neither wants the other to have more control. Accordingly, it is extremely common for each party to assign a 50% shareholding to the other with the belief that this will mitigate any future problems as nothing can happen without consensus.

Whilst this is a sensible idea, where relationships deteriorate or decisions cannot be made because of disagreement, the resulting circumstances is a shareholder (and often director) deadlock.

Shareholder deadlock will often pervade through to the shareholders' decisions as directors (unless they have appointed a third director, which is a wise decision) and may lead to a breakdown of the company business, by reason of it being unable to function and, in the worst case scenario, the company may cease to trade as a result.

Another common problem is where new parties join the company, or perhaps of the two original parties one is putting in more investment, and there is a situation where one holds a smaller interest than the other. This can also be a mechanism for ensuring voting can occur to avoid shareholder deadlock (described above). An example may be where one shareholder/director owns 60% of the shares and the other owns 40%.

Alternatively, you may have a husband and wife relationship where somebody with key skills joins the company and is granted a small shareholding (for example 20%) to retain loyalty and his/her involvement in the company.

In any of these circumstances the minority shareholder (be that the historic one or the new entrant) will have little or no ability to control the affairs of the company as their vote relies on the goodwill of others and may, in the best case scenario, only be required for special resolutions (which are rarely required for company business).

The additional disadvantage of having a minority shareholding is that a valuation of that share will not be equal to the relevant percentage of the company (as a result of the limited voting rights described above).

Further problems may then occur if the minority shareholder's view on how the business should operate is not listened to or the assets of the company begin to be removed without his/her authority.

Even when the minority shareholder is a director on the board, there may be difficulties if there are two or more other directors (as the majority always determines the company's vote in board meetings) and even where that minority shareholder may only be matched against one other director (for example where only two directors exist and there is deadlock), a simple shareholders general meeting can remove the minority shareholder from his position as director by reason of the requirement for an above 50% vote by shareholders to remove a director.

4 How do I protect my minority interest?

The protection of a minority interest is very difficult despite the fact that directors always hold a duty of trust and confidence in respect of all the shareholder's interests.

Essentially, a company should be run with directors acting in all shareholders' interests and there should be no need to seek to protect minority shareholders because the directors should always act in their interests. However, in reality this is unlikely and the best way to protect a minority shareholder's interest is to ensure a shareholder's agreement exists or is drafted for the company's shareholders.

A shareholder's agreement may dictate additional rights that minority shareholders may have, remedies that they may seek and resolutions if they want to exit the company. A shareholder's agreement is an extremely valuable document but will not be registered at Companies House and therefore, once executed, should be kept in a secure location (usually with your solicitor or with the companies' books and records) to enable you to call upon it or refer to it at a later date.

5 What if directors do not listen or pay attention to a shareholder agreement?

A shareholder's agreement is a legal agreement between shareholders and, as with any other contract, a party can be sued in damages for breaching the agreement. A shareholder's agreement may itself provide a remedy for any such circumstance.

Directors ultimately have a duty to all shareholders to act in accordance with their requirements and the existence of a shareholder's agreement, providing it is circulated and known to all directors, is something that they must pay attention to.

In addition to the shareholders agreement, directors can be personally liable for breaching their fiduciary duties to any group of shareholders under Section 178 of the Companies Act 2006.

Ultimately, if the directors are not adhering to such requirements and are acting in breach of the rights of the minority shareholder then it is a necessity to remind them of such rights and duties and the potential consequences (which are outlined in our other articles).

If a director continues to fail to adhere to such duties then s/he could be in breach of his/her fiduciary duties and therefore, become personally liable to the company and may be sued by the company in this respect or alternatively, may face liability under the terms of the shareholders agreement, which can be enforced by the minority shareholder suffering as a consequence of his/her director's actions.

6 How does the company sue a director?

Obviously, the first thing that a minority shareholder will query is, even if the director is in breach of his/her fiduciary duties then if he continues to remain as a director it is likely that the company will never take steps to ensure adherence to those fiduciary duties.

There are two options here, firstly if a shareholder's agreement exists then there are contractual rights binding all shareholders personally and the company must act in accordance with such rights (as per the statutory requirements set out in the Companies Act 2006). Of course, the minority shareholder may require that the company continues to trade and therefore enforcing such rights against an individual director/shareholder may disrupt the claim by tipping off the director and/or disrupt the general management of the company by that individual (which would also not be in shareholders' interests).

This is certainly a risk to consider, although in most cases by this point the minority shareholders may have decided that such steps are now unavoidable.

Taking proceedings against a co-shareholder/director, who may be wealthier as a result of such behaviour, is a decision which is not made lightly as it is normally the case that the minority shareholder has a lower level of resources or funds available to fund such steps. Indeed, a director may be able to use company funds to defend himself.

To improve this position, and ensure justice is achieved, the second option is the statutory remedy whereby the minority shareholder could take proceedings against that director via the company as co-claimant.

These proceedings are called statutory derivative proceedings which is a claim that historically existed at common law but which has now been set down in detail by the Companies Act 2006.

Whilst the minority shareholder does have to incur some legal costs in demonstrating to the court that the case has merits, once the merits are accepted by the court then the minority shareholder has the ability to take proceedings against that director on behalf of the company (which means that the company will fund such further legal costs).

This can be very expensive and is only a course of action to be taken where serious breaches exist and substantial losses have been caused as a result of the director's breach of fiduciary duties owed to the company.

7 How can minority shareholders be protected in a deadlock situation?

As described above, it is not uncommon for two shareholders to exist and each rightly hold 50% of shares to represent their equal interest (with both of them usually being appointed a director).

In this situation, no one party who can pass any ordinary resolution and both directors must always consent to all major decisions taken at a board meeting in respect of the company. A two person managed/co-owned company can only ever operate where both parties act jointly and are in agreement in respect of all matters.

Where relationships fail and those two parties fall out then each of them is a minority shareholder and each of them may have complaint against the other for acts s/he is doing whilst acting as a director of the company.

It is important to note that, to ensure a company can operate on a day-to-day basis (amongst other reasons), a company will usually be bound by all contracts or agreements entered into by a single director, and it is not an uncommon situation where a director may continue to trade the company and incur losses or lose assets (subject to certain statutory restrictions, which may not be adhered to) without the other shareholder/director's consent.

A common solution to these problems is to allocate a majority vote to a specific individual on the board of directors, usually the chairman. This can be reflected in the articles and is sometimes referred to as the golden vote (or the golden share for shareholders meetings).

Alternatively, where the indecision exists in an identical way in respect of shareholder resolutions, a nominal share could be allocated to a third party to eliminate this risk (although the affiliation of that third party may present further difficulties).

The ideal solution to such problems is the existence of a shareholder's agreement, which can provide to a mechanism to break such a deadlock in a neutral way which cannot be disputed by either party. How this works is for discussion between the shareholders and depends considerably on the business itself and the respective parties' requirements and expectations.

8 What solutions ultimately exist for minority shareholders?

As stated above, as a minority shareholder the percentage shares that you hold for a company does not reflect the percentage of the company's value that you have an interest in (on the basis of any market valuation).

If such shares were sold on the open market then that value would be reduced to reflect the lack of interest in any such shares (especially in a private limited company) that would be given where they do not have any voting rights.

Where the company is going in a direction that was not originally intended by that shareholder, or where the return from the company is not reflecting its success, then the ultimate objective of a minority shareholder will be either to force the company to act in the way sought (if reasonable) or alternatively the shareholder will need to negotiate or force his/her exit from the company.

There are a range of ways discussed in our other articles as to how you exit a company but this may be on the basis of an independent valuation, petition to wind-up the company or seek a remedy directly from the co-shareholder via an unfair prejudice petition.

The court can be required to make an order forcing the company to buy the minority shareholder's shares in certain circumstances or require the other shareholder to buy their interest (subject to affordability and finances).

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