SMES, DIRECTORS & SHAREHOLDERS

What happens when directors and shareholders fall out?

7 frequently asked questions

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INTRODUCTION

Shareholders and directors are two separate categories of individual with interests in the ownership of a limited company (shareholders) and/or the management of a limited company (directors).

Often it is the case that such individuals are family or friends, with a history in the relevant market and share a common objective and enthusiasm for the business, whilst initially understanding each other's role (but perhaps without any detailed documentation of such matters). as the company develops and grows the requirements of such duties, roles and obligations become increasingly important and it is at this point when parties' relationships may start to sour, maybe because one or more are doing more work than the others or where one or more appear to be taking more money than the others.

In this article we try to address the options available to shareholders/directors when they fall out and how they can deal with such a fall out.

1 What are the usual circumstances of dispute?

Often it is the case that there is a central sales or operations director who deals with the day to day business of the company and there is one or more other directors who deal with a more technical role – usually IT or the financial side of the business. This other director (or directors if more than one) is largely non-client facing and has little involvement in the business itself other than the infrastructure (which it could be argued, dependent on the company, may be the most important part of the business).

We see a number of different situations arising in such circumstances – for example the operations director may complain that the financial director is drawing more salary for him/herself out of the company (or vice versa) or there may be claims of overdrawing of expenses, a redirection of business to competing companies and/or an acquisition of staff, all of which may be in breach of the wrongdoing director's fiduciary duties to the company.

The specific circumstances are too numerous to list here but a dispute over money is not uncommon and indeed is usually the main source of disagreement between directors, who are usually also the company's shareholders.

An alternate difference arises in respect of the directors' expectations as regards the company's future business plan and the expected return on investment. One director may have put slightly more investment into a company than the other and thereafter decides to have little or no role in the company. The director running the company may complain that the absent director is not pulling his/her weight and doing as he was expected to do or alternatively the absent may complain that the other director is not allowing him/ her into the company and is drawing monies that s/he is not entitled to.

The most common cause of dispute is that the company's business is going in a direction that the absent director (whether absent by consent or otherwise) did not agree to and, in light of the inability of the directors to make any alternate decision as regards the company (because of a deadlock between both directors and shareholders) this non-participating director cannot influence or control the active director's activities.

2 What are the possible consequences of such disputes?

There are serious consequences that can arise out of these type of situations which will affect all shareholders and directors of the company, regardless as to whether they were involved in these events or not.

If a key director is removing assets from the company, either by way of a direct removal of such assets or by way of transfer of them to an associated party, then if the company ever went into insolvency proceedings that loss could be personally reclaimed from each and every recipient and each and every director by way of misfeasance, regardless of their level of involvement.

Obviously, it goes without saying that the removal of assets from the company will erode the company's ability to continue trading (especially if it is in a delicate financial position) and may ultimately affect its going concern status.

If a director is removing funds on a regular basis from the company then the company's profit will diminish and these activities may lead to various future tax liabilities arising which may be claimed against the company by HMRC (regardless as to whether the director subsequently repays such sums). in these circumstances, if tax liabilities arise which are not immediately repaid, HMRC may petition for the liquidation of the company, and any subsequently appointed liquidator may then seek recovery of such sums against that director and potentially against the other directors by way of their fiduciary duties to ensure that such risk was mitigated.

Directors, whether directly involved or not, may also face director disqualification proceedings for misconduct in having "allowed" such events to occur.

3 How does the company prevent directors falling out?

It is always recommended that a company does not have an even number of directors so that decisions can always be made by way of a majority vote.

The existence of at least three or five directors (or more) will mean that in any deadlock situation all directors have to pick a side and ultimately there will be a majority decision (although whether this is right or wrong may be something for consideration at a later date). in small companies, the decisions by directors are also ultimately decisions by the same individuals as shareholders and thus the distinction between these roles are often blurred.

However, this can lead to circumstances where one director who was outvoted having to consider his rights as a minority shareholder, in the absence of any ability to otherwise control this situation from board level. This is a classic circumstance where directors fall out, as an alternative to a situation where a voting deadlock occurs.

Ultimately, an uneven number of directors will ensure that deadlock between directors is avoided and the company is continuously able to make decisions (although whether those are the right or wrong decisions will depend on the individual circumstances).

4 What can shareholders do when directors fall out?

If directors fall out and a genuine wrongdoing has occurred then ultimately the continued involvement of the perpetrator(s) in the company's business will be prejudicial to the company's interests.

At the same time, the non-wrongdoing directors have a duty to prevent this damage from escalating and if other directors (either passively or otherwise) continue to allow these circumstances to continue then they run the risk of later be made personally liable for the loss caused as a result of these actions.

One example of this (amongst many) is the offence of wrongful trading under Section 214 of the insolvency act 1986. We refer to our booklet "Wrongful and fraudulent trading" which address this issue. In summary, where a company continues to trade when the directors "ought to or should have known that liquidation was unavoidable" then all directors can be personally liable in damages and disqualified by way of director disqualification proceedings for either causing or allowing the company to continue trading.

Ultimately, if shareholders (either in this capacity or whilst acting simultaneously as directors) cannot control such behaviour then a majority of them have the ability to remove the perpetrator director from his position. However, this may cause further problems in terms of that director's role, how to replace him/her and the damage such action could cause to the company.

5 How do shareholders remove a director?

A director may be removed by way of a shareholders resolution passed at a general meeting of shareholders convened upon special notice being given to the director.

The resolution passed need only be an ordinary resolution, requiring the approval of more than 50% of the shareholders present, either in person or by proxy, at the shareholders meeting. If more than 50% (not 50%) of the vote cannot be achieved then it is pointless calling such a meeting for these purposes.

There is no need for all shareholders to physically appear at the meeting, provided some are attending, as another shareholder can act as your proxy and vote in accordance with your request. However, it is always recommended to attend (particularly if there is a possibility of a close vote and you have an interest in the outcome).

If minority shareholders (unless supported by other shareholders in excess of the 50% required) cannot remove directors in this way they may alternatively have to seek the court's assistance.

6 What are a director's rights when they are to be removed?

A director must receive at least 28 days notice of a shareholders meeting convened for these purposes. Other shareholder resolutions can be passed with less notice or event on paper.

The 28 days' notice is a term of special notice, which is a legal requirement for any steps taken to remove a director (as the contentious nature makes it very controversial and of important consideration in respect of a company's affairs).

A director has a statutory right to make representations to shareholders to either explain the circumstances at the meeting and/or provide an explanation for the steps he has taken before the shareholders are required to vote on the proposed resolution. If this right is not adhered to then any shareholders resolution to remove that director will be invalid.

However, provided these requirements are adhered to, then the director's removal will be final and should be immediately recorded in the company's records and at Companies House.

7 What other solutions exist if shareholder/directors fall out and a director cannot be removed?

If the wrongdoings cannot be remedied, either by persuasion or by a majority vote of directors, and a shareholders resolution cannot be passed to remove the perpetrator director, then the only solution may be that the shareholder/directors will have to part company and go their separate ways.

This may be a solution that is achieved amicably, either on the basis of an agreed valuation sale of the company's shares and payment plan. Please see our booklet entitled "What can a shareholder do to exit a company?" which addresses this solution.

if however an exit by way of a negotiated solution is not possible, then it may be that proceedings are brought against the perpetrator director or the situation requires the liquidation of the company (which can be done as a solvent liquidation or an insolvent liquidation). a solvent voluntary liquidation (which is perhaps the least contentious method of liquidating the company) will require the consent of a majority of shareholders and an insolvent liquidation (where a company either has more liabilities than assets or cannot pay its debts as and when incurred) will require a petition usually by a creditor (where directors cannot agree this).

If the disgruntled shareholders are unable to achieve either of these, then (provided the company is solvent) they can petition the court to wind-up the company up on a statutory just and equitable basis.

Such a petition is normally accompanied by an unfair prejudice petition with the wrongdoing director a party, which may provide an opportunity for the company to be rescued as a going concern by either the company or the other director being ordered to buy out the petitioning shareholder's shares on the basis of an agreed valuation of the company's business and assets.

The exit options are numerous and carry many risks and it is recommended that you seek legal advice should you wish to pursue such options.

Should you require any further assistance at all in this area of the law, please contact one of our director and shareholder specialists and we can help today.