SMES, DIRECTORS & SHAREHOLDERS

What can shareholders do to control directors?

8 frequently asked questions

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INTRODUCTION

The historic case of Fosse v Harbottle [1843] led to the rule in Foss v Harbottle which sets out the distinction between the legal entity of a limited company in UK law as opposed to the legal entity of its owners or its management (i.e. its shareholders and directors).

The owners of a limited company will normally be its shareholders for conventional limited liability companies. The rule in Foss v Harbottle states that those do not have the power to take any proceedings or enforce any rights of the company, which is a distinct and separate legal entity acting under the management of directors.

The reason for this distinction is that there are many stakeholders in a limited company (not just the shareholders).

A company exists to fulfil the desires of shareholders (generally to generate profits and provide income) without the shareholders having any personal commitment or risk in allowing such an entity to continue trading, other than their initial investment and ongoing interest. This benefit is required to be balanced out by the need for the company to act independently of all interests (including its shareholders) and the need for comprehensive levels of financial information to be publicised by the company annually at Companies House.

1 What is the role of directors?

Directors are independent from shareholders at law (although for small to medium size companies they are often the same individuals) and have the responsibility of running the company on a day-to-day basis which will include its operations, its strategic direction, its finances, sales and all other decisions made pursuant to the company's business objectives.

Under Section 171 of the Companies Act 2006, directors have a primary fiduciary duty to always act to promote the success of the company, and this generally refers to the generation of profits and maximisation of benefits devolving to shareholders.

Because of the separate role directors have from shareholders, directors also have a statutory responsibility to act independently of all interests other than the company's and to declare any personal interests in transactions they may have or any other conflict their personal interests may have with that of the company. These duties include responsibilities owed to all other stakeholders including employees, creditors and the public.

Unfortunately, it is not unusual for directors to act in conflict with shareholders' interests, or perhaps a group of shareholders' interests (whether they be majority shareholders or minority shareholders). In these circumstances the director(s) acting in conflict with such interests may well be acting in the company's interests as a whole; alternatively they may not and as a result may be in breach of their fiduciary duties to the company.

It is at this point when due consideration needs to be paid as to whether such decisions have been made properly, can be changed, are truly in the company's interest as a whole or do they unfairly prejudice a group of shareholders?

2 How are director's decisions made?

Under Section 40 of the Companies Act 2006 directors have the power to bind the company to contracts and other commitments without seeking the approval of co-directors or shareholders (subject to certain statutory restrictions and any restrictions within the company's articles of association and any shareholders agreement).

At common law a director will often be delegated the function to make specific decisions so that the company can operate on a day-to-day basis, but on more important aspects there will usually require a resolution of the board.

It is highly desirable that all substantial transactions are authorised by directors together at an executive board meeting, rather than directors dealing with such decisions in isolation. Any decision made by a director in isolation can be at risk of being criticised at a later date. However, from a third party's point of view dealing with a company in good faith, the commitment by a director to a transaction will always bind the company to that agreement (provided they are appointed and subject to any restrictions as described above).

Directors are generally recommended to meet at least once a month to monitor the affairs of the company and ensure good corporate governance in respect of its financial situation and its strategy. Directors should also discuss at such meetings any conflicts of interest, professional advice given and any transactions which are proposed to be entered into by the company.

The constitutional documents for the company, namely the Articles of Association and any shareholders agreement drafted for the company, will define the limit of the directors' powers and authority. However under a standard set of Articles of Association a director can more or less deal with the company's assets and business as he sees fit provided he can justify such decisions by reference to board agreements, the company's objectives and the business considerations generally.

3 What decisions require shareholder input?

Chapter 4 of the Companies Act 2006 contains a breakdown of specific transactions which require the approval of shareholders. This will be subject to any private agreement between shareholders ("the shareholders agreement") which may require the approval of shareholders for specific categories of transaction as determined under the shareholders agreement.

One type of transaction which requires shareholders' approval is where the director seeks to be employed by the company under a service level agreement which is or may be longer than two years. In such circumstances, shareholders are required to approve the employment guaranteed under that employment contract.

Another transaction which requires shareholders' approval is where the company seeks to enter into a substantial property transaction with one of the directors. This is required whether the company is buyer or seller. As such a transaction is at risk of great fraud within the company's accounts, especially in terms of the valuation assigned to any such asset and the director's ability to affect the valuation assigned to the asset in question, then shareholders are required to vote on such matters.

However this requirement does not apply to cash assets.

There is also a statutory requirement for any loans to a director, be that in cash or otherwise, to be authorised by shareholders.

However there are six exceptions to this rule which relate directly to the director's ability to continue running the company and in such circumstances shareholder approval may not be required, as it would otherwise impede the ability of the company to function on a day to day basis. One example is where the director acts in proceedings brought against himself personally for breach of a fiduciary duty and he seeks the company's assistance in paying his legal fees for defending such matters.

4 What about payments to directors who are dismissed or resigned?

Where directors are dismissed or otherwise compensated for the loss of their office as a director then the company may not make such a payment to the director unless this payment has been approved by shareholders.

In agreeing such a resolution shareholders must initially receive a memorandum outlining the particulars of the payment to that director, which would normally be broken down into the various amounts paid, the reason for payment and any final payment terms. Without this memorandum then any shareholders resolution approving such a payment is invalid.

There is of course a de minimus amount below which no such shareholder approval is required (as this would be uneconomic). This amount is £200 and any payment to a director for loss of office below this sum does not require shareholder approval.

5 What liability exists for any such transactions not made with shareholder approval?

Under the Companies Act 2006 there are several mentions of the civil consequences of contravention in respect of the transactions which require the approval of shareholders.

As a broad brush, the general rule is that any such transactions (and the benefit of such transactions) are held in trust for the shareholders by the receiving director and the directors who approved any such transactions will be, if relevant, jointly and severally liable for the same sums.

This is a statutory extension of the liability that directors may face for any breach of their fiduciary duties. Accordingly, strict compliance with these rules is essential to prevent them returning by way of proceedings brought by the company, its shareholders or any subsequently appointed liquidator or administrator up to six years after the date of the original transaction.

6 How can any such transactions be prevented?

Shareholders are entitled to detailed financial accounts and annual reports on an annual basis within nine months of the financial year end. For small companies the abbreviated accounts filed at Companies House are not sufficient to be circulated to shareholders, who require the conventional format of financial accounts including a profit and loss account, a balance sheet and the relevant notes to such accounts (including remuneration details for directors).

It is of critical importance that shareholders continuously review the financial accounts provided to them on an annual basis and be sure that full disclosure of all information they are entitled to is required.

Shareholders can also seek an audit of the company's accounts if they have the appropriate size of shareholding and they make such a request before the financial year-end (and within certain statutory time limits).

Constant engagement with the directors of the company or, for larger companies, a constant review of the financial information produced, is of critical importance to safeguard shareholders' interests in a company where they are not otherwise engaged in the business.

Without any involvement then a shareholder of a private limited company (which will be considerably less policed and bears a much higher risk of fraud) may very well find that the company takes steps which s/he does not agree with, and they may find that the return from their investment is not satisfactory or doesn't fall within their original expectations.

7 What other powers does a shareholder have?

Aside from the requirement to seek shareholder approval on certain matters, generally directors have an unfettered power to run the company and manage its business. Shareholders' only interests are in the financial returns and the success of the company which, if the directors act in accordance with their fiduciary duty, should be left to the directors.

However, if a breach of trust occurs between directors and shareholders, or shareholders suspect that any or all directors are acting outside of their statutory or corporate powers and they are unable to engage the directors or otherwise seek a solution internally, then shareholders can take matters into their own hands and commence more formal steps.

If a sufficient majority of shareholders approve, by ordinary resolution shareholders can remove a director from his/her position on the board, but this carries the risk that the director may sue the company for unfair dismissal or any other breach of his/her employment rights.

In addition to this there is always the ongoing problem of how the company can run its business where it removes a director who may be critical to the company's operation (despite any apparent breach of duties that are simultaneously ongoing).

If this solution is not available, then the only other recourse is to the courts. Obviously the issue of any legal proceedings is a potentially costly matter and should be done with care, as it is not uncommon for shareholders to perceive that directors are acting against their interests whereas the directors may in reality be doing their utmost to promote the success of the company and so advice should certainly be sought before issuing proceedings.

The legal costs in litigation proceedings can be very high and the risk of such proceedings falls on both sides.

We refer to our separate articles entitled "Shareholder powers in a company" and "What happens when shareholders and directors fall out?" which both outline the statutory routes available to shareholders.

In summary shareholders can take proceedings on behalf of the company against directors (derivative proceedings) both whilst in situ or after the directors' dismissal, or shareholders can issue proceedings against their co-shareholders (who may also be directors) for acting in conflict with other shareholder interests generally, especially where the complainant shareholder is a minority shareholder (these are referred to as unfair prejudice proceedings).

8 When do directors lose their legal duties to act in shareholders' interests?

There are a variety of circumstances where other priorities take over the statutory and common law duties of directors, which would normally be to act solely to promote the success of the company and in shareholders' interests.

Where a company is insolvent then directors have a duty to act in creditors' best interests (rather than shareholders' interests) and they are relieved of their duties to shareholders in favour of the interests of unsecured creditors. Therefore, where the company is insolvent, directors' decisions may be very different to what a shareholder would expect in a conventional profitable trading circumstance.

Later, to protect creditors, it may be necessary that the company be placed into insolvency proceedings, a decision which would directly oppose the will of shareholders. Directors are protected in such circumstances, as there is a statutory provision allowing directors to make such a recommendation or seek the company's winding-up without the authorisation of shareholders.

Aside from this there are other business related issues which may affect the ability of shareholders to enforce their rights, including matters where the company operates in a regulatory environment and has an obligation to make certain payments or take certain steps which may be perceived as contrary to the shareholders' interests.

Shareholders' interests cannot be prioritised over any other legal duties of either the company or its directors, and directors cannot be required to use the company or any of its employees for any illegal purpose. Such purposes could include the deliberate avoidance of tax liabilities owed by the company or its employees.

Should you require any further assistance at all in this area of the law, please contact one of our friendly director and shareholder team members and we would be happy to help you today.