SMES, DIRECTORS & SHAREHOLDERS

Shareholder powers in a limited company

8 frequently asked questions

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INTRODUCTION

Limited companies in England and Wales are managed by parties separate to those who have a financial interest in the success of the company.

The managers, or directors, of a limited company will make all executive decisions as regards the business, its finances, its operations and all other issues relating to the running of the business and its success, including its expansion and the acquisition of property (subject to some statutory limitations).

Alternatively, the investors (or owners) of the company (shareholders) each hold a specific amount of the fixed pool of shares in the company but have no day-to-day involvement in the company and do not have any entitlement to remuneration. They will be responsible for all decisions relating to the structure of the company, including the rights and obligations of shareholders and directors, the constitution of the board (subject to directors' powers to recruit co-directors) and the disposal of assets to connected parties.

Quite often in small and medium size companies the shareholders and directors are the same individuals, or have many common representatives.

The power of individual shareholders are often dependent on the amount of shares they own (i.e. the proportion of the company they own) and personal relationships between the respective shareholders. Majority shareholders are those with more than 50% of shares and minority shareholders generally refer to those having 50% or less shares. A 50% share is not a majority because it must be more than 50% to constitute a majority.

1 Where do shareholders powers originate from?

A source of shareholders powers is generally found within the constitution documents for a company, which in England and Wales is referred to as the articles of association ("the articles") and memorandum of association. The latter document is rarely a source of reference, but the articles are very important as they define the powers of shareholders, the powers of directors and general restrictions applicable to the company.

The articles can of course be amended by a shareholders resolution, and the amended document must be registered at Companies House and, together with the shareholder resolution, retained within the company's accounting records so that there is an accurate record of such changes to the articles.

The other source of reference is the legislation provisions, most importantly the Companies Act 2006 and various other regulations which have been annexed to this very large piece of legislation. As well as this there are the companies acts that have been passed over the course of the last century which will often contain a vital element of relevance to the articles, often referred to as Table A, dependant on when the company was incorporated.

2 What is a shareholders agreement?

A shareholders agreement is a private contract between shareholders of the company. It binds all such shareholders to any such agreement, together with the company.

A shareholders agreement is a private document and is not registered at Companies House and therefore is not something available for public view and the use of it therefore depends greatly on the shareholders who are a party to it retaining a copy and being aware of its existence (as they can often be forgotten or overlooked after some years).

A shareholders agreement is a very useful tool and will cover a whole range of situations relevant to both the shareholders' interests and the operation of the company, and may govern what the directors can and cannot do, what entitlements each of the shareholders should receive, who is entitled to any shares sought to be sold by any of the shareholders and how any legal or other remedies should be dealt with.

The aim of a shareholders agreement is to prevent or minimise the effect of any disagreement, any deadlock which may cause the company problems and any risk to third parties as a result of disagreements between either shareholders or management.

The potential content of the shareholders agreement is too large an issue to be covered in this article but, in summary, if there is any bespoke arrangement you require in respect of your interest in a company, this can be reflected in a shareholders agreement.

A shareholders agreement is a very technical document and accordingly we strongly recommend that you seek legal advice when drawing one up. We often see scribbled notes or even more comprehensive documents which shareholders often seek to rely on. For a number of reasons, these documents are often partially or entirely unenforceable.

3 Common disputes that arise in a company

Most small to medium size companies often face a conflict between individual directors or directors/shareholders at some point.

Common disputes that arise often include a complaint by one shareholder/director that another one is either removing or taking more income in excess of the other's drawings, or his/her role is not as originally expected, the business is not going in the agreed or preferred direction, assets are being diverted to someone's personal interests or to a corporate entity which was not agreed, or there is just a complete inability to make decisions within the company.

A commonly encountered situation is where shareholders, who at the outset were unwilling to allow the other shareholder too much control, have equal 50/50 shareholdings and find themselves unable to reach any agreement on business or financial decisions, or even shareholder resolutions as regards such matters, for example dividends.

This is often referred to as "shareholder deadlock" and is a great source of dispute between shareholders who often are very emotionally involved and may in some situations not be considering the pragmatic aspects of the situation. Please read our booklet entitled "Company deadlock – the options" for more information on these matters.

4 What risks do shareholders face?

When a dispute arises between shareholders (who may often also be directors), whilst emotionally at war with each other they may lose focus on their primary concern, i.e. the company.

We often see a lot of situations where disputes arise that severely damage the company and accordingly both shareholders (who may also be directors) could as a result be in breach of their fiduciary duties to the company.

In such circumstances, where the two directors fail to promote the success of the company, a minority shareholder could potentially sue them personally for the damage caused by this distraction.

In the alternative, if the directors are not causing losses to shareholders generally, then it may be that their actions are incurring losses to third parties (most particularly creditors) who will likely be less sympathetic to their personal concerns and have greater legal remedies available, including those against the company itself.

A shareholder dispute will often cripple a company if left untethered and accordingly parties need to enter dialogue quickly. Quite often this is not possible and the only recourse may either be that the company fails or legal advice is sought to resolve the situation.

The benefit of a solicitor or an accountant being involved cannot be underestimated (despite the cost). They will have no emotional stake in the company and will be able to look at the situation objectively and clearly, in order to assist the directors/shareholders in making the correct decision to settle any such dispute.

It is not uncommon for the situation to deteriorate as a result of the fear of professional fees, but in a majority of circumstances those fees repay the cost by dealing with the problem early with less overall losses to the company.

5 What legal action can be taken against a co-director?

We often see situations where one director controls a vital part of the business, be that they are the main contact on the sales side, they deal with the finances or and are exploiting this position to pay him/herself a higher salary (which sometimes may be justified), are drawing assets or cash from the company without agreement, are running competing companies or are acting in any other way so as to jeopardise his/her business partner's interests (be that a prejudice to the company's value or to income streams).

This situation can often lead to the other director, who may have the same shareholding and equal powers to his/her co-director, having no real ability to prevent such behaviour or take remedial action within the company.

The legislations (the Companies Act 2006) does provide a minority shareholder (which is what a 50% shareholder effectively is) with a power to bring unfair prejudice proceedings against a co-director in such circumstances.

Such proceedings can be brought against them personally and against their personal assets, if required, as otherwise taking action against them as a director of the company may ultimately lead to the claimant paying half of any settlement (which therefore makes the application unproductive) as a result of any contractual arrangements within the company or under the statutory rules which allow a director to have the company pay for his/her legal advice in defending legal actions brought against them as director.

Alternatively a co-director may wish to bring proceedings on behalf of the company against that director, where the losses have been caused to the company itself rather than the shareholder(s).

These can either be brought by firstly dismissing or suspending the director with the remaining directors resolving (on behalf of the company) to issue conventional proceedings against that director. This is only an option where a majority of directors can agree on any such suspension and a majority of shareholders (more than 50%) can resolve to dismiss the perpetrator.

This is often difficult as it is quite common for such an individual to hold either a majority of shares or be familiar with a sufficient number of shareholders to ensure that no majority vote is passed.

At this point the Companies Act 2006 provides a remedy, allowing minority shareholders to issue derivative proceedings against the perpetrating director on behalf of the company (which, if initial stages are successful, can also fund such proceedings).

However, such proceedings may be costly and the very use of them is usually sufficient to bring the disputing parties to the table in light of the threat of extensive legal costs and the uncertainty of any judgment.

6 What is the court's attitude?

The court is very unwilling to get involved in shareholder disputes where there is a legal mechanism for such disputes to be resolved, either by way of the decisions made by the board of directors or by way of resolutions passed by shareholders.

Ancillary documents, most particularly the articles and any shareholders agreement, will dictate how involved the court need to be.

However the court does recognise that sometimes there is an imbalance on the board or in respect of the ownership of company shares, the effect on decision-making and the interests of various shareholders. In such circumstances the court will intervene where necessary to correct this imbalance or to ensure that all shareholders have their interests reflected by the company.

The court's view is that the company constitutes all of its shareholders, not just those who hold a majority of the shares, and therefore any decisions being made by a shareholder/director which favours him/her yet prejudices other shareholders may be subject to a close examination and is at risk of being reversed.

The court also has to bear in mind the fact that a director at common law should not act in favour of his own interests where they conflict with those of the company, and the requirement to declare his/her personal interest in any transaction. Ultimately, if these requirements are not adhered to then the court may make an order restoring the position or rectifying circumstances such that the transaction is reversed.

However, and equally, a court has to ensure that it maintains the integrity of the economic marketplace and will not act so as to undermine the equitable powers of a legitimate majority shareholder who does no more than to otherwise act in accordance with his fiduciary duties to promote the company's success and return funds to shareholders in accordance with the original expectations of all shareholders.

7 How does a shareholder or director exit a company?

Conventionally a shareholder or director exit is arranged by negotiation. Directors are either employees, self-employed or act purely in their legal capacity and therefore can simply resign their position.

However resigning as a director will limit your ability to be involved in most decision-making by the company and should be carefully considered before any such resignation is tendered.

Once tendered for resignation it will be incredibly difficult to gain reappointment without endorsement of some or all directors, especially if you fear that the company is making decisions or is rescinding an offer previously made in respect of your shareholding.

If a director is to be removed, then this is a matter for shareholders to vote on. However, for most small to medium-sized companies, the shareholders and directors are the same individuals and thus this distinction may not be as relevant. Mirrored to this is the other directors' requirements to adhere to their fiduciary duties – if continually allowing the perpetrating director access to company information, financial documents or other parts of the business is prejudicing the company, then an urgent restriction on their role is vital. In such circumstances it may be appropriate to seek a suspension of that director's role to ensure no further damage is done.

As regards the exit of shareholders, the ability to sell shares will often be subject to the pre-emption rights contained within the articles and any shareholders agreement.

If no such pre-emption rights exist, then shares may be sold on the open market (subject to valuation issues) but if pre-emption rights do exist then usually they must be offered to the other shareholders of the company.

The valuation of such shares is an important consideration in such circumstances, as unlisted companies may be valued by a variety of methods, including on earnings, on the balance sheet or on the basis of the business itself. It is important that the valuation is carried out by someone suitably qualified and is sufficiently independent, to avoid any conflict. Once a valuation is agreed and accepted, this will form an excellent basis for any negotiations in respect of a shareholder's exit (which should normally be set out in an agreement to protect against any future consequences, including taxing liabilities, arising).

Sometimes pre-emption rights are exclusive, such that the shares cannot be sold at all on the open market and accordingly a shareholder may be limited to the benevolence of their co-shareholders, who will often not offer an amount which the shareholder thinks their shares are worth. Please see our booklet entitled "What can a shareholder do to exit a company" for more information".

If this is unacceptable then, in the absence of shareholders resolving to amend the articles to allow the exiting shareholder to sell such shares to a third party, the only remaining solution is the nuclear option.

8 What is the nuclear option?

If no agreement can be reached to buy out your shares and you really do want to exit a company then the only remaining option may be to apply for a winding-up of the company on a just and equitable basis.

This can be done in conjunction with a petition for unfair prejudice (where a genuine dispute or complaint as to a director's conduct exists) or where a shareholder wishes to force a buyout of its interest by the other shareholders.

A company can buy out shares of a shareholder but often this would be subject to the ability of that company to buy such shares and whether it has sufficient reserves for this purpose under the legislation.

A court will not force a company or co-shareholders to purchase shares where they plainly cannot afford it and in such circumstances may offer to wind-up the company on a just and equitable basis (despite the potential overall loss in value that may occur as a result of the commencement of liquidation).

If the company is wound-up on a just and equitable basis at court, it must firstly be solvent, otherwise the shareholder has no interest in the winding-up proceedings, and a liquidator will be appointed to collect all assets of the company and liquidate any non-liquid assets and pay all creditors off and then pay the surplus to shareholders in the proportion that they own the shares.

The liquidator's fees and expenses will of course come out of this and will dilute the value of the company but in some circumstances this nuclear option may be the only viable solution for a shareholder to exit.

Should you require any further assistance at all in this area of the law, please contact one of our shareholder experts today for help.

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