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UNFAIR PREJUDICE PETITIONS – LESSONS TO BE LEARNT AND RECENT DEVELOPMENTS

When entering into a corporate relationship, few contemplate an acrimonious split some years down the line. Even with carefully documented agreements, including exit provisions, relationships can turn sour and expectations may not be met. Whether a majority or a minority investor, it is important to understand the remedy of unfair prejudice both to ensure you can best guard against it and utilise it should the need arise.

Whilst there are a number of causes of action for aggrieved shareholders, we are seeing an increased use of the statutory protection afforded for unfair prejudice, notwithstanding it being an expensive and fraught process. This is often a process called upon to bring the relationship to an end but is equally an effective tool to take control of a company or ensure that conduct is regulated going forward.

This eBulletin summarises the grounds for bringing an unfair prejudice petition and draws some lessons to be learned from four recent cases this year.

TOP TIPS TO AVOID OR REDUCE THE IMPACT OF AN UNFAIR PREJUDICE PETITION:

- **Documentation:** Decide what relationship you wish to have with your fellow shareholders at the outset, and whether you wish to minimise the risk that your relationship will be found to be a quasi-partnership. Carefully document this, including any management rights for shareholders. While a shareholders' agreement is not by itself inconsistent with a quasi-partnership, shareholders' agreements which contain clauses expressly excluding the relationship of trust and confidence reduce the risk of a finding of a quasi-partnership relationship (see below for why this matters). Ensure any new agreements or understandings are properly reflected in the documentation.
- **Record keeping:** Where the minority shareholders are likely to be adversely impacted by a decision, make sure the company properly documents why that decision is in the best interests of the company (as opposed to in the best interests of some of the shareholders).
- **Avoid a conflict:** Where directors use their powers to pursue their own interests (or those on whose behalf they have been nominated) as shareholders, not only is this at risk of being a breach of fiduciary duty but also grounds for an unfair prejudice petition.
- **Separation:** Bear in mind that an individual's conduct as a director does not mean that they can be deprived of their shareholder's interests. If faced with a difficult situation with a director/shareholder, take care not to trespass on their shareholder's interests (which can include a right to be involved with management of the business). If unavoidable, you may need to consider making them a fair offer for their shares.
- **Valuation:** Unfair prejudice disputes are costly, time consuming and often involve "airing dirty laundry in public". As the petitioner's goal is likely to be a share buyout, consider whether it is possible to value the shares and make an early offer to buy the minority's shares. This will involve seeking early expert advice on the value of the shares.
- **Resolution:** A straightforward valuation of the petitioner's shares might give rise to difficulty. There may be other issues that need to be determined first before a valuation can be carried out, such as what adjustments should be made to reflect any breaches of duty by the majority shareholders. Think creatively in coming up with alternative solutions that might work.

GROUNDS FOR BRINGING AN UNFAIR PREJUDICE PETITION

The basis of unfair prejudice actions is statutory. The test is set out in section 994 of the Companies Act 2006. In order to bring a successful unfair prejudice action, three requirements must be satisfied:

1 The conduct complained about must be conduct of the company's affairs.

The concept of a company's affairs is broad. It includes anything which might properly come before the board for consideration. Matters concerning both a parent company or a subsidiary company can be caught as impacting upon a company's affairs. It captures both acts and omissions.

While it does not capture the activities of shareholders among themselves (such as dealings with their shares) it will bite if those activities translate into acts or omissions of the company. A shareholder casting its vote is an exercise of that shareholder's private rights, and not of itself conduct of the company's affairs. However, the passing of a shareholder resolution pursuant to which a company does or does not take a step, is an act of the company which is capable of founding an unfair prejudice petition.

2 The conduct must prejudice the petitioner's interest as a shareholder

The petitioner must be a shareholder (they can be the majority shareholder). Beneficial owners of shares held by nominees may not petition. Equally, a petitioner cannot use this remedy to protect his rights as a director (save for where there is a quasi-partnership) or a creditor.

The main sources of a shareholder's interest in the company are, most obviously, the company's memorandum and articles of association. Prejudice to the petitioner's interest as a shareholder

generally requires damage to the financial position of a shareholder (such as damage to the value of a shareholding). Unfair prejudice actions are often premised on a shareholder's expectation that they have a right to be a director or a right to be involved in the company's management from which they have been excluded.

3 The conduct complained of must be unfair

There is no provision for "no fault divorce" under the unfair prejudice regime – unless there is unfairness, the petitioner will not be entitled to relief. A petitioner will be able to complain of unfairness where there has been a breach of the company's memorandum or articles, or where there has been a breach of a collateral agreement between the shareholders (such as a shareholders' agreement) or breach of a legitimate expectation. A company's conduct will be unfair where the directors have acted in bad faith or for an illegitimate, ulterior purpose.

QUASI-PARTNERSHIPS

In some circumstances additional equitable principles apply which mean that lawful conduct which abides by the company's constitutional documents is, nevertheless, inequitable and unfair. Equitable principles apply where the company is, in reality, a quasi-partnership and the shareholders have a legitimate expectation that other shareholders will not exercise their rights in a way which would be unfair to them. This will often be the case in small, private companies. Legitimate expectations only arise in quasi-partnership relationships. A company may be a quasi-partnership where, for example: the relationship between the shareholders is formed or continued on the basis of a personal relationship, involving mutual confidence; there is an agreement or understanding that all the shareholders will participate in the management of the business; or there are restrictions on the ability to freely transfer shares. Such a relationship can exist even where it is not reflected in any shareholders' agreement (though a no partnership clause helps to avoid the risk of a finding of a quasi-partnership).

In a quasi-partnership relationship, there is a presumption that the exclusion from management of a minority shareholder will constitute unfair prejudice unless it is accompanied by an offer to buy the minority's shares at a fair value[1].

REMEDIES – WHAT CAN YOU EXPECT?

The court has a wide discretion to make any order it thinks fair and equitable which is most likely to remedy the unfair prejudice suffered[2]. The remedy is adaptable and corrective, not punitive. The court does not have to limit itself to the relief the petitioner wants or desires, and a successful petitioner is not entitled to any particular form of relief. The discretion is so wide that the petitioner's own conduct may be taken into account in deciding whether and what relief to grant.

However, the most commonly sought relief and the most popular order is an order that the majority buy the petitioner's shares. This severs the relationship between the parties and provides a clean break.

The court encourages fair value offers to be made to the petitioner to buy them out at a price to be determined by an independent valuer. Thought should be given to this option at an early stage of an unfair prejudice petition as an unreasonable refusal to accept an offer can provide grounds to strike out the petition wholesale. However, even if this is accepted in principle, there may still be various issues which need to be determined before a fair valuation can be carried out (such as whether the petitioner's conduct should be taken into account).

Other remedies the court may order include:

- an order that directors transfer property to the company which was acquired by them in breach of their fiduciary duties;
- an order requiring the company to refrain from, or to do, a particular act;
- an order authorising the petitioner to bring civil proceedings in the name of the company;
- an order that the petitioner's shares be bought out;
- it is possible, but rare, for the court to order a company to distribute its assets to the shareholders; or
- the court also has the power to order the minority to purchase the majority's shares, but again this is rare as the majority are usually better placed to continue to run the company's business and the minority shareholder usually has insufficient funds to buy out the majority shareholders.

VALUATION – KEY PRINCIPLES

If the court orders the shares to be bought out, then the court will require the assistance of an expert valuer. The basis of that valuation is an important and often costly issue. If it is inevitable that an unfair prejudice dispute will end in an independent valuation, consider seeking to narrow the factual issues in dispute at an early stage and obtain an early valuation (in agreement with the other side). This will help to focus settlement discussions and could assist with cutting through parts of a costly court process.

Minority shareholdings are usually subjected to a pro rata value discount. There is no rule about what that discount should be, and the level of the discount is something a valuer will opine on having

[1] See *Re BC&G Care Homes Ltd; subnom Crowley v Bessell and others* [2015] All ER (D) 115 for a recent example of this.
[2] See T*homas v Dawson* [2015] EWCA 706 by way of example.

regard to a multitude of factors including the voting rights attached to those shares, any directorship rights and the likely identity of a buyer. In the context of an unfair prejudice petition, the value of a minority shareholding will not usually be discounted when the company is a quasi-partnership. In those circumstances, it is more usual for the court to simply value the shares by reference to a pro rata value of the company as a whole. Conversely, where the company is not a quasi-partnership, a discount will usually be applied though not always. Whether the company is a quasi-partnership or not is therefore acutely important to the value of the claim.

The court may also make other adjustments to the valuation in order to achieve a fair result. It may, for example, order that the valuation be made on the hypothetical basis of various factual assumptions which seek to put the petitioner back in the position he/she would have been in but for the unfairly prejudicial conduct. Equally, it may seek to compensate the petitioner for the unfair prejudice suffered even where that did not significantly impact upon the value of the shareholding[3].

The date of the valuation is generally the date of the order for the purchase of the shares. However, this is subject to the court's discretion[4]. If valuing the shares as at the date of the order is likely to cause unfairness, the court will choose a different valuation date.

Finally, the fact that the majority shareholders might not be able to afford to buy the minority shareholder's shares will not stop the court making such an order, although the court has in some cases ordered payment on deferred terms.

The recent cases that form the basis for this note are listed below. For a more detailed summary please click on the relevant links:

- Arbuthnott v Bonnyman: The case of *Arbuthnott v Bonnyman & Ors* [2015] EWCA Civ 536 demonstrates the use of the unfair prejudice remedy (unsuccessfully in this case) to challenge the exercise of rights under the articles by the majority shareholders. This case confirms the circumstances in which an alteration to a company's articles may be challenged as invalid.
- Thomas v Dawson: The case of *Thomas v Dawson* [2015] EWCA 706 demonstrates the breadth of the discretion conferred on the court when ordering relief under s.994. Despite the Company being balance sheet insolvent, the court ordered that the petitioner be granted an option to purchase the majority's shares at a fixed price and be permitted to continue to have conduct of the management of the company.
- Re BC&G Care Homes Ltd: The case of *Re BC&G Care Homes Ltd; subnom Crowley v Bessell and others* [2015] All ER (D) 115 (Jun) demonstrates the impact of a quasi-partnership on the available relief. As a useful reminder of past authorities, it was held that in such circumstances, the removal of the petitioner's right to be involved in the management of the company was unfair in the absence of a fair offer to acquire his shares.
- Birdi v Specsavers: The case of *Birdi v Specsavers Optical Group Ltd & Ors* [2015] EWHC 2870 demonstrates the impact of wrongdoing on a fair valuation of shares and how things can go wrong when directors use their powers to pursue their own interests. The court ordered that the price payable for a petitioner's shares should include a sum to make good the prejudice that has been unfairly suffered by Mrs Birdi, even though the prejudice did not depress the value of the company or Mrs Birdi's shares.

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[3] *Birdi v Specsavers Optical Group Ltd & Ors* [2015] EWHC 2870.
[4] In *Re KR Hardy Estates Ltd* [2014] EWHC 4001 (Ch) the valuation date was held to be the date when business was diverted from the company.

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